A behaviourally plausible decision centred perspective on the role of corporate governance in corporate failures

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The primary focus of this thesis is to answer "What is the role of corporate governance in corporate failures? Does poor corporate governance lead to corporate failures? If so how?". In doing so the thesis examines the literature from multiple fields including corporate governance, corporate failures and organisational decision making, and identifies a research gap to analyse and explore the relationship between corporate governance practices and corporate failures through a behavioural lens.

In approaching this, a qualitative research methodology is adopted to analyse the failure of Enron Corporation and Nathans Finance Ltd. The research considered the case study organisations as the primary unit of analysis and the decision makers as the secondary unit of analysis. Based on this research approach, the thesis reports the analytical results drawn from extensive and triangulated secondary data. The thesis then interprets the results in the context of the theoretical synthesis.

The thesis contributes towards filling a gap in the research and presents a behaviourally plausible decision centred model of the role of corporate governance in corporate failures. The model highlights the critical role of the behavioural aspects of corporate governance decision making in corporate failures, and focuses attention on the underexplored aspects of corporate governance decision making.

The thesis also suggests a further understanding of *'A Behavioral Theory Of The Firm'* (Cyert & March, 2001) in relation to corporate failures.

Keywords: Corporate governance, Coporate failure, Decision making, Behaviour, Values, Case study, Qulitative research.

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Chapter 1

Introduction

1.1 Background

Corporate governance has been a much-discussed topic in recent years with notable cases of corporate failure and abuse of corporate governance around the world being the primary source of problems in the past twenty years. These cases have included a list of prominent companies like Enron, WorldCom, Barings Bank etc. (Mardjono, 2005) and the failures have brought misfortune for those directly or indirectly associated with the corporations. A series of formal investigations and reports followed these failures, and considerable effort has been put in to the development of best corporate governance codes, practices and theory worldwide (Leung & Cooper, 2003). However, these developments have failed to put a halt to corporate governance failures. Why are the current theories, practices and codes of corporate governance unable to provide a solution to this recurring problem? Could it be that we simply do not understand enough about the corporate governance decision process? (Leblanc & Gillies, 2005).

These failures have triggered a series of formal investigations in many developed and developing countries. For example, in the UK alone, there have been four significant inquiries providing important recommendations on corporate governance. These include Cadbury (1992), Greenbury (1995), Hampel (1998), and Turnbull (1999). In the United States, the government has enacted the Sarbanes- Oxley Act as a protective measure against corporate failure. On a further note, good corporate governance principles and practices have been adopted by various bodies such as the OECD, ASX Council and the New Zealand Securities Commission. According to Carter and Lorsch (2004) a majority of the good corporate governance practices are focused around the need for independent directors; the need to have a board leader who is not the Chief Executive Officer (CEO); the requirement for boards to have at least three core committees - audit, compensation, and corporate governance (or nomination) - the members of which should all be independent directors; the need for boards to be as small as is feasible and for directors to be compensated enough to motivate them to focus upon maximising shareholder value (Carter & Lorsch, 2004).

However, it seems that whatever the actions taken another failure is just around the corner somewhere in the world. For example, legislation and the encouragement to follow best practices failed to prevent the recent sub-prime mortgage market debacle, the effects of which rippled out from the USA to world lending markets. It seems that there is a gap between best practice theory and the practice. It may be that whilst board empowerment and independent action as well as aligning directors' interests with those of owners are important, this principled stance simply does not translate into practice. So, what is it that is missing and why is it that the deployment of best practice continues to fall short, resulting in major failures in governance? Could it be that we simply do not understand how boards operate (Leblanc & Gillies, 2005)?. Perhaps the major issue in corporate governance research stems from our limited understanding of what really goes on in directors' minds and inside boardrooms (Smallman, 2007).

The need to study the role of corporate governance decision processes in effective corporate governance has been widely recognised in past literature (Argyris, 2000; Dowling & Pfeffer, 1975); however many, including Bhagat and Bolton (2008); Rutherford and Buchholtz (2007); Rutherford, Buchholtz, and Brown (2007); and (Donaldson, 2012); Huse (2005) recognise that the main focus in this context has been on studying the demographic characteristics of the board including board composition and size; tenure of the board members; CEO duality; and the board and CEO remuneration. According to Rutherford et al. (2007), the research focusing on the demographic content has been significant in terms of their findings, but it fails to examine the corporate governance decision process. However there is a significant need to examine the *“intervening processes and behaviours”* associated with corporate governance decision making (Rutherford & Buchholtz, 2007).

Another dominant feature of corporate governance research has been the use of quantitative research methods by a majority of the corporate governance researchers (Leblanc & Schwartz, 2007). However according to Letza, Kirkbride, Xiuping Sun, and Smallman (2008) corporate governance is not a purely economic process but a social and interactive process as well. Most of the doctoral students and scholars in the past have carried out research using data and methods that can be evaluated by journal reviewers through well-established validity concepts. The usual board measures employed in these studies are CEO duality, insider/outsider ratio, the number of board members and the directors’ share ownership (Finkelstein & Mooney, 2003; Huse, 2005; Johnson, Daily, & Ellstrand, 1996; Krause & Semadeni, 2013; Shi, Connelly, & Sanders, 2016). Actual board behaviour is not explored in these studies. A very small portion of the empirical board articles published in the leading scientific management journals are about actual board behaviour(Gabrielsson & Huse, 2004). So, what is needed, perhaps, is to examine the *processes* of governance, rather than the *structures*.

1.2 Current Understanding and Research Gap

There is a significant need to study corporate governance decisions and practices, as despite best efforts, corporate failures have been haunting the corporate world. All kind of actions and development of best practices in the field of corporate governance have failed to provide a solution to the problem of corporate failures. As stated previously, the current research and developments in corporate governance practice and research fail to acknowledge the importance of behavioural aspects in corporate governance decisions. There seems to be a gap between best practice theory and practice (Smallman, 2007). Thereby, this study aimed to analyse and explore the relationship between corporate governance practices and corporate failures through a behavioural lens. This is depicted in the title of the study: *A behaviourally plausible decision centred perspective on the role of corporate governance in corporate failures.* The study is decision centred as it focuses on the corporate governance decisions and decision making of the selected cases, and is behaviourally plausible as it aims to understand the behavioural context of corporate decision making.

This research adopts a qualitative methodology to explore the role of corporate governance in corporate failures in the context of the behavioural aspects of decision making, thus contributing towards addressing the inadequacy of theory in this regard. The primary research question that drives this research is:

> *"What is the role of corporate governance in corporate failures? Does poor corporate governance lead to corporate failures? If so how?"*

In doing so the study considered the case study organisation as the primary unit of analysis and the decision maker as the secondary unit of analysis.

1.3 Theoretical Base

To craft a theoretical storyline (Golden-Biddle & Locke, 2007) this study examines literature from multiple fields including corporate governance, corporate failures and organisational decision making. In the beginning the intention was to carefully review selected works for the literature review. These studies were selected on the basis of frequency of citation. Some of the content was recommended by my supervisors. Following the concept of progressive coherence (Golden-Biddle & Locke, 2007) some of the sources required further analysis, where the related citations were followed back to retrieve further information. The objective was to construct a coherent synthesis of the literature and to highlight any gap that the research could contribute towards. Here the corporate governance literature falls into three categories that include shareholder perspective (Letza et al., 2008), stakeholder perspective (Letza et al., 2008)and behavioural approaches (Carter & Lorsch, 2004; Leblanc & Gillies, 2005) to corporate governance. For the purpose of this study the model of corporate failure provided by Stead and Smallman (1999) is selected due to its ability to synthesise a wide literature on corporate failures. In the context of organisational decision making, '*A behavioral theory of the firm*' by Cyert and March (2001) has been selected for its ability to support this research in terms of intervening in decision processes. The theory was first published in 1968, but for the purpose of this research the 2001 edition is considered.

1.4 Research Methodology

As stated previously corporate governance research has been dominated by quantitative methods. However, this study uses qualitative methods to explore the behavioural aspects of corporate governance decision making in context to corporate failures. Qualitative research was selected for this study after consideration of its ability to explore a phenomenon or concept in a novel way, differently from quantitative research (Creswell, 2003). According to Creswell the unique strength of qualitative research is that it allows issues and ideas to emerge and does not suggest or indicate anything in advance. Since it is expected that new realities may emerge during data collection (Creswell, 2003) a qualitative research approach is justified as it facilitates explanatory inferences (Creswell, 2003; Hubberman & Miles, 2002). Most importantly, the qualitative research approach is considered suitable for research studies that focus on "what" (exploratory nature only), "how" and "why" components (Yin, 2009, pp. 8-9), which justifies the use of qualitative methodology for this research.

This research uses a case study approach as it has the unique strength to deal with a full variety of evidence e.g. documents, artefacts, interviews, and observations (Yin, 1994). This research uses a variety of documented sources that include newspaper articles, journal articles, legal proceedings, court documents, books, public enquiry reports, archival records, and media reports. The research is based on two cases: Enron Corporation and Nathans Finance Ltd and uses the purposeful sample (Levrau & Berghe, 2013; Marshall, 1996) that had the potential to answer the research questions.

Enron was a US based multinational company that went bankrupt in 2001. It was once considered the most innovative and successful company in America, winning awards and accolades before going bankrupt (Downes & Russ, 2005). Today Enron is known more for its downfall than for its past success – a fall that brought havoc (Arnold & Lange, 2004) to the US economy, causing billions in losses. On the other hand, Nathans was formed in July 2001 as a wholly owned subsidiary of a vending technology company - VTL Limited. The company went bankrupt in 2007 (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011).

The research follows a replication approach to multiple-case studies (Yin, 1994). Each individual case study consisted of a "whole" study, in which convergent evidence was sought regarding the facts and conclusions for the case; each case's conclusions were then considered to be the information needing replication by the other case (Yin, 1994).

A qualitative research software NVivo was used to assist in analysing the data.

1.5 Intended Contribution

The research intends to contribute to the existing body of knowledge by exploring the role of the behavioural aspects of corporate governance decision-making in corporate failures. In this way the research aims to address the research gap identified in Chapter 2. In doing so the focus will be on addressing the issue of "inadequate" (Golden-Biddle & Locke, 2007) literature to explain the role of corporate governance in corporate failures. The research will focus on the processual nature of corporate governance (Letza et al., 2008), an area not duly represented in present literature. Further details on this research gap are provided in Chapter 2.

A Behavioral Theory of the Firm by (Cyert & March, 2001), is an important part of this research. This research intends to contribute towards the further understanding of the theory in the context of the behavioural aspects of corporate governance decision making. In this way the research intends to explore the theory in the present context and contribute towards closing the research gap presented in Chapter 2.

1.6 Thesis Structure

This thesis comprises seven chapters including the Introduction. Chapter Two presents a review of the literature on corporate governance, corporate failures and organisational decision making. It contains a synthesis of the literature and presents a gap for the research. Chapter Three presents the rationale for the research methods and data analysis. Chapter Four presents the individual case narrative for Enron, and the narrative of Nathans's is presented in Chapter Five. The findings of the research are presented in Chapter Six. Chapter Seven consists of discussion based on the findings presented in Chapter Six, and also presents conclusions and prospects for future research.

Chapter 2

Literature Review

As explained in Chapter 1, the current developments in corporate governance practices have failed to prevent corporate failures. There is a difference between best practice theory and the practice, along with a limited understanding of corporate governance decision making and the intervening processes, especially in context of the behaviour of decision makers. Accordingly, this thesis is undertaken to analyse and examine the process of corporate governance decision making (in the context of the behavioural aspects) rather than the structures.

This chapter reviews the current literature on corporate governance and corporate failure in order to understand current thinking about the role of corporate governance in corporate failures. The first section explores corporate governance literature in terms of definition, theoretical perspectives, principles and practices, and behavioural aspects. The second section defines corporate failures, and presents the trends in corporate failure research, along with a presentation of related theoretical paradigms. The last section of the chapter presents the research gap and summarises the chapter.

2.1 Corporate Governance

This research explores the role of corporate governance in corporate failure, hence it is necessary to develop an understanding of the concept of corporate governance.

2.1.1 Background

The origin of corporate governance goes back to the 1600s, when the governance structure of the East India Company consisted of an executive body called the Court of Directors, who managed the company on behalf of the Court of Proprietors. This structure was quite similar to the present day corporate governance structures and also faced issues such as the separation of ownership and control (Cadbury, 2002). The origin of modern day corporate governance was divided into four phases by Hann (2001). The first part belonged to the 1980s and the highlights include the growing number of takeovers, mergers and acquisitions and a significant rise in executive compensation. Most of these developments relied on financing through junk bonds and raised the debt ratio of the organisations. Thus this phase marks the developments in corporate governance to deal with the above issues and to improve the performance of the organisations. The second phase (starting early 1990s) consisted of changes in the regulatory framework in the context of the management of corporations. These changes (such as improved communication with shareholders and disclosure of director compensation) had a significant impact on the governance of corporations in terms of meeting the regulatory requirements. The third phase (starting mid 1990s) saw the rise of electronic media, thus affecting the availability of information. This increased the accessibility of information about the operations and governance of corporations, by the shareholders. The fourth phase (starting from the mid to late 1990s) was the rise in institutional shareholdings, resulting in an active role for these institutional investors in the governance of corporations (Hann, 2001). Another important aspect of modern day corporate governance is the attention that this concept has received, primarily due to the recent corporate failures. Developments such as the Code of Best Practice (Cadbury, 1992); Principles of Corporate Governance (OECD, 2004); Corporate Governance in New Zealand Principles and Guidelines (*Corporate Governance in New Zealand: Principles and Guidelines*, 2004) constitute a significant part of present day corporate governance. The details on these developments are provided in the later sections of this chapter.

2.1.2 Defining Corporate Governance

Corporate governance has been a well-researched area in last decade (Young & Thyil, 2014), however according to Cohen, Krishnamoorthy, and Wright (2010) "despite the importance placed on corporate governance in academia and practice in recent years, there is still no universally accepted definition of corporate governance". This section provides insights from the previous literature into the definition of corporate governance.

According to the Committee on the Financial Aspects of Corporate Governance, "Corporate governance is a system by which companies are directed and controlled. The boards of directors are responsible for the governance of the company, which includes setting strategic aims, providing effective leadership, supervising management, and reporting to shareholders on their stewardship" (Cadbury, 1992). Similarly Brickley and Zimmerman (2010) "corporate governance is the system of laws, regulations, institutions, markets, contracts, and corporate policies and procedures that direct and influence the actions of the top-level decision makers in the corporation". These definitions refer to corporate governance as a system and highlight that the board of directors of a company assumes the primary responsibility for governing the organisation and signifies that the board operates within the boundaries set by the regulatory and legal systems, the internal constitution of the company itself and the shareholders of the company.

Forbes and Milliken (1999) also have a similar opinion on defining corporate governance and state that the main functions of boards are control and service functions. In terms of control functions, the board is legally responsible for monitoring the working of management with adequate care and responsibility and, under the service function, the board is required to participate actively in strategy formulation and providing advice accordingly (Forbes & Milliken, 1999). Another similar opinion on corporate governance is that it is a set of functions that include setting strategic direction, policy formulation, selection of the CEO, risk management and control, legislative compliance, monitoring performance, and reporting on stewardship (*Corporate Governance: A Director's Handbook*, 2004). On reviewing the above definitions, it becomes clear that the focus here is on corporate governance as a system which consists of various functions which are required to be performed to run the affairs of the organisation so as to meet the related expectations.

On similar lines, Pass states that corporate governance represents the duties and responsibilities of a company's board in managing the operations of the company and maintaining relationships with the shareholders and other stakeholders of the company (Pass, 2004). According to Pass (2004), corporate governance is equally responsible for maintaining relationships with other stakeholders, which indicates that good corporate governance needs to meet the expectations of shareholders as well as other stakeholders. This opinion is widely held by the supporters of the stakeholder perspective on corporate governance. The concept of the Stakeholder Perspective is discussed in detail in the coming sections.

According to the ASX Corporate Governance Council (*ASX Corporate Governance Principles and Recommendations*, 2007) corporate governance is the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account. It further states that corporate governance influences the way the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised (*ASX Corporate Governance Principles and Recommendations*, 2007). The OECD Principles on Corporate Governance define corporate governance as *"a set of relationships between a company's management, its board, its shareholders and other stakeholders".* Corporate Governance also *"provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined"* (OECD, 2004). These definitions of corporate governance also focus on its functions, but extend the scope to further add aspects such as the interests of stakeholders, the relationships between various related parties, and processes. These definitions also point to the qualitative aspects of corporate governance by focussing on 'how' the corporate governance functions are performed.

The New Zealand Securities Commission defines corporate governance *as "the set of structures and behaviours by which a company or other business entity is directed and managed"* (Securities Commission, 2003). This definition highlights that good corporate governance depends not only on structural elements but on behavioural aspects as well. Conger, Lawler, and Finegold (2001) also hold a similar opinion on behavioural aspects and state that *"…. it is behavior [sic] that counts with respect* *to boards, not the practices per se* ….”. The importance of behavioural aspects is also supported by Young and Thyil (2014) who observe that “Corporate governance needs to draw on behavioural frameworks rather than what is often seen in practice as structural approaches”.

In summary, the literature defines corporate governance as a system that consists of a series of functions to be performed by the board of directors, which are guided by various rules and regulations. The board of directors is the pivot point of corporate governance, but good governance requires the management of the relational aspects of decision making including internal and external stakeholders. Most of the literature focuses on the structural elements of corporate governance, but the importance of the behavioural aspects is also evident. For the purpose of this research corporate governance functions include setting strategic direction, formulation of policy, managing and controlling risk, selecting a CEO and directors, monitoring performance, legislative compliance and reporting. In saying that, it does not mean that this research is limited to these functional aspects only. The following sections will further unfold the context of corporate governance for the purpose of this research.

2.1.3 Corporate Governance - Theoretical Perspectives

The above definitions of corporate governance broadly present it from three different perspectives. The first is the shareholding perspective, which consists of the narrow scope of maximising shareholders’ interests only. The second is the stakeholding perspective which advocates maximising the interest of all the stakeholders. These two perspectives challenge each other in terms of the fundamental purpose and scope of corporate governance. The third perspective is the behavioural perspective, which considers board behaviour as an essential element of corporate governance. The following sections further explore these perspectives in detail.

The Shareholding Perspective

The shareholding perspective holds that the shareholders of a company provide capital to the company, and in return the managers of the company are supposed to use that capital only in a way authorised by the shareholders (Aras & Crowther, 2016, p. 107; Hasnas, 1998; Smith, 2003). Berle (1931) was one of the early proponents of the shareholding perspective and stated that the interests of the shareholders should be the driving force for the managers of a company. Similar views were presented by Milton Friedman in his seminal work published in 1962. According to Friedman*, “the corporation is an instrument of the stockholders”* and “*there is one and only one social responsibility of business- to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engage in open and free competition, without deception or fraud”* (Friedman, 2002, pp. 133,135).

Jensen and Meckling (1976) also supported the shareholding perspective, which they related back to the pioneer work of Adam Smith (1776) – The Wealth of Nations. They highlighted that the corporations have a separation of ownership and control, thereby adherence to the shareholding perspective will safeguard the interests of owners/shareholders. Sternberg (1995), another proponent of the shareholding perspective, stated that the objective of the company is the maximisation of owner value. However, he affirmed that the company should focus on long term value maximisation and that the behaviour of stakeholders is intrinsic to the long-term value maximisation.

The Anglo-Saxon Model

The shareholding perspective is represented by the Anglo-Saxon model (Ahmad & Omar, 2016; Cernat, 2004). It is the basic model of the shareholding perspective and all the other models, in this context, emerge from the Anglo-Saxon model (Ahmad & Omar, 2016). The model, which is also referred to as the Anglo-American model, the market-centric model, the equity-based model, the principal-agent model and the finance model (Ahmad & Omar, 2016), is the most dominant model of governance (Keasey, Thompson, & Wright, 2002, p. 3).

The model assumes that the objective of an organisation is maximisation of shareholders' wealth and is based on the separation of ownership and control, which leads to an agency relationship between the owners/shareholders and the managers of the organisation (Jensen & Meckling, 1976). The separation of ownership and control leads to agency problems in the form of conflict between owners and managers (Berle, 1931). Agency problems arise when the agent pursues different objectives from the principal (Letza et al., 2008). According to Davis, Schoorman, and Donaldson (1997), both the principal and the agent are motivated by their own personal gain, leading to a clash between the self-serving agent and the profit oriented principal. Eisenhardt (1989a) states that along with the conflicting goals of the principal and agent, another issue is that it is difficult for the principal to monitor the work and behaviour of the agent. Since the model is based on the relationship between the principal and the agent, which is guided by relationship contract (Jensen & Meckling, 1976), the focus of the model is on finding the most efficient contract as a measure of good corporate governance (Eisenhardt, 1989a). According to Eisenhardt (1989a), these measures aim to monitor the behaviour and output of the agent. Such measures include incentive programs for management (Fama, 1980; Jensen & Meckling, 1976), information systems, budgetary and reporting procedures and alignment of the owner's and agent's interests (Eisenhardt, 1989a), and focus on aspects such as governance and board structure, ownership and control and rights of various stakeholders including shareholders etc. (Ahmad & Omar, 2016).

Stakeholding Perspective

The stakeholding perspective challenges the shareholding perspective in terms of the purpose of the organisation (Letza, Sun, & Kirkbride, 2004) and has emerged out of the criticism of the shareholding perspective (Donaldson & Preston, 1995; Freeman & Reed, 1983; Mansell, 2013).The stakeholding perspective advocates that management has a fiduciary duty to both the shareholders and other stakeholders (including customers, suppliers, employees and community) who affect or are affected by the achievement of company's objectives (Freeman, 2001). According to Freeman managers are responsible for ensuring that the legitimate interests of all the stakeholders are attended. The stakeholding perspective considers that stakeholders are not merely a means to an end but have the right to participate in determining the future direction of the company (Freeman, 2001).

The stakeholding perspective asserts that organisations need to manage the interests of all the stakeholders, whether they result in improved financial performance or not. The focus here is not on the maximisation of owner value but on "coordinating stakeholder interests", which indicates that at times there might be conflict among the interests of the shareholders and other stakeholders. According to the stakeholding perspective, in such situations management is required to strike an optimal balance, which means that at certain times the interests of the shareholders might be sacrificed or might not be prioritised, as was the case in the shareholding perspective (Hasnas, 1998).

The Continental European Model

The Continental European Model or the Continental Model is the basic model that represents the stakeholding perspective (Ahmad & Omar, 2016; Cernat, 2004), which is the basis of all the other models for governance based on the stakeholding perspective (Ahmad & Omar, 2016). It is also referred to as the Stakeholder Model (Letza et al., 2008; Turnbull, 1997) and presents the most fundamental challenge to the Anglo-Saxon Model (Keasey et al., 2002, p. 8).The model not only considers the interest of shareholders but the other stakeholders as well (Cernat, 2004).

The model proposes that the organisation has a wider objective than merely the maximisation of the shareholders' interest. Rather the interests of the groups who have a long term association with the organisation should be explicitly recognised. The wider objective of the organisation is for it to be equitable and socially efficient. The model is efficient in two principal ways. Firstly it helps the organisation in developing an ethical organisation's reputation by providing ethical treatment to the stakeholders, which further results in building trust relations that lead towards profitable ventures and mutual cooperation. Secondly, the success of Japan's and Germany's organisations, which have adopted this model and adopted wider stakeholder interests, supports the model as a choice for good governance (Keasey et al., 2002, pp. 9-11).

Comparison - Shareholding Vs Stakeholding Perspective

The debate between the shareholding perspective and the stakeholding perspective (Letza et al., 2004; Smith, 2003) has dominated the corporate governance literature since 1980s (Letza et al., 2008). Moreover, the criticism of the shareholding perspective leads to the stakeholding perspective. Therefore it is important to compare these two competing perspectives before proceeding to the third perspective, which is comparatively new and has not been compared to the other two perspectives (details to follow).

Both the shareholding and stakeholding perspectives are widely supported and recognised in the present literature, which is non-coherent (Golden-Biddle & Locke, 2007) in nature and is linked by disagreements. According to Jensen (2001), the value maximisation proposition of the shareholding perspective is based on 200 years of research in economics and finance, and its competing contender, the stakeholding perspective, belongs to the field of sociology and organisational behaviour.

The shareholding perspective, although it focuses on the maximisation of shareholder value, pursues only legal and non-deceptive means to earn those profits. When an organisation follows legal and honest means to earn its profits, it automatically justifies its responsibility towards the other stakeholders. Moreover, shareholders supply money to the organisation and the management is under contract to use it in a way approved and consented to by the shareholders (Hasnas, 1998).

However, Donaldson and Preston (1995) have responded (in advance) to the above support for the shareholding perspective. They state that pursuing only the interests of shareholders is normatively unacceptable, especially considering the legal expectations (that also include social responsibility) from a corporation. According to them a business cannot ignore social and ethical requirements (including the interests of other stakeholders) if it wants to pursue a profitable venture in the long run. Responding to the notion of the property rights of shareholders, the authors state that *"the notion that property rights are embedded in human rights and that restrictions against harmful uses are intrinsic to the property rights concept clearly brings the interests of others (i.e., of non-owner stake- holders) into the picture"* (Donaldson & Preston, 1995).

But Jensen supports the shareholding perspective on the grounds that the stakeholding perspective is impaired by the politics of special interests and the self-interest of management. Jensen criticises the stakeholding perspective as incomplete in terms of providing guidance to the managers and leaves them in a dilemma in deciding on what is good and what is bad for the organisation. Jansen further states that the incomplete nature of the stakeholding perspective makes it a perfect tool for serving the self-interest of outsiders, managers, and the directors of the organisation. The stakeholding perspective is considered to be fundamentally flawed as it fails to deliver a single-value objective to facilitate rational decision making (Jensen, 2001). However, referring to Jensen's criticism of the stakeholding perspective, Sacconi (2004) responds that the criticism does not stand well against the "social contract of the firm" and that the distributive conflict among various stakeholders can be resolved by mutual cooperation and bargaining among the various stakeholders.

On the other side Mansell (2013) argues that organisations can pursue the shareholding perspective, and can still take care of the interest of other stakeholders. According to Mansell, it is possible to critique the shareholding perspective without a competitive rival's perspective. It is suggested that organisations can bring transparency to their operations and can adopt an ethical code of conduct and corporate social responsibility policies to represent the interests of other stakeholders. Mansell supports the shareholding perspective while rejecting the idea of a competitive perspective:

> *…… theorists cited at the start of the article employ a range of ethical theories to oppose the orthodox shareholder view; however, it appears that by extending the shareholder theory rather than by rejecting it outright, the well-being of non-shareholders can be part of the corporate objective, and in many cases ought to be (Mansell, 2013).*

On the opposite side the proponents of the stakeholding perspective posit that it offers a broader approach to running an organization and considers a wide range of governance issues as compared to the shareholding perspective (Mason & Simmons, 2014). Tantalo and Priem (2016) state that adoption of the stakeholding perspective can help organisations move beyond the narrow shareholder perspective. They state that with integrated decision making organisations can simultaneously serve the interests of different stakeholders and managers need not trade-off between the interests of different stakeholders. They advocate taking advantage of opportunities to create shared value that serves the interest of all the stakeholders including the shareholders. They provide the concept of 'stakeholder synergy' which *"allows top managers to truly create value for essential stakeholder groups, rather than resorting to trade-offs that only transfer existing value among the groups"* (Tantalo & Priem, 2016).

Amidst these contradictions, Daily, Dalton, and Cannella (2003), (Roberts, McNulty, & Stiles, 2005),Letza et al. (2008), Hambrick, Werder, and Zajac (2008) and Ees, Gabrielsson, and Huse (2009) call for corporate governance research in new directions, including decision processes and behaviours. For instance, Letza et al. (2008) address the need to focus on the underlying philosophical issues in corporate governance, as they argue that corporate governance is not a pure economic issue that can be fixed between the above two perspectives. Rather it is social in context and processual in nature and affected by non-economic factors such as cultural and social factors.

The processual nature of corporate governance challenges the conventional and fixed approaches to governance (shareholding and stakeholding) (Letza et al., 2008) and represents a gap in corporate governance research.

Behavioural Perspective

As identified earlier, the third corporate governance perspective is the behavioural perspective. This perspective has been largely ignored in corporate governance research (Erakovic & Overall, 2010; Huse, Hoskisson, Zattoni, & Viganò, 2011; Leblanc & Gillies, 2005; Pye & Pettigrew, 2005; Roberts et al., 2005). However, behaviour has been recognised as an important element of corporate governance, for example, the shareholding perspective refers to the attitudes and behaviours of the principal and agent that affect their decisions (Eisenhardt, 1989a; West, 2009). Huse (1998) emphasised that it is most essential for the organisations to deeply understand board behaviour; however, the following quote from Leblanc and Gillies (2005, p. 134) indicates a lack of research in this regard:

> *…. it is truly astonishing, given the enormous amount of work on corporate governance ………… how little has actually been learned about how boards actually function …. learning "how boards work" [sic] could have tremendous practical significance for the governance of corporations.*

Roberts et al. (2005) not only raise the issue of the lack of research in terms of the behavioural perspective, but also state that most of the behavioural research focuses on the structure, composition and independence of the board of directors and ignores the actual conduct of the directors. Similarly Huse (2005) supports the lack of research in terms of behaviour and states that most of the research, though aimed at focusing on the behavioural perspective, explored concepts like CEO duality, the size of the board, the ownership interest of the directors and the percentage of independent directors. The author further stressed that corporate governance research also needs to explore the role/behaviour of actors (decision makers/boards of directors) to gain a wider understanding of the behavioural perspective (Huse, 2005). According to Pye and Pettigrew (2005) a study of board behaviour in terms of power, politics, learning, risk assumption, change and adaptation can provide important insights in this context.

However, the behavioural perspective and related research is gaining momentum (Ees et al., 2009), for example, *International Journal of Disclosure and Governance* published a special issue in 2013, focusing on the critical components of corporate governance that included the behaviour of boards of directors (Leblanc, 2013). Hambrick et al. (2008) have raised the issue of 'Behavioural Structure' and 'Behavioural Process' in the boardroom, while Minichilli, Gabrielsson, and Huse (2007) state that the decision making culture, interaction among boards of directors, and trust levels and emotions can provide meaningful insights into corporate governance processes. Similarly Erakovic and Overall (2010) focused on the behavioural perspective in terms of inter-relationships and inter-personal communication in the organisations.

Despite the above developments and research, Mostovicz, Kakabadse, and Kakabadse (2011) state that the current behavioural perspective fails to explain the behaviour of decision makers in the wake of corporate failures. The authors observe that human aspects/behaviour are still overlooked in the present research, and that it is important to study the factors influencing the behaviour of corporate decision makers (Mostovicz et al., 2011). To conclude, Ees et al. (2009) state that the research related to board behaviour is in its initial stages and there is a need to develop a theory explaining board behaviour (Ees et al., 2009). Before addressing the issue of the lack of theory explaining board behaviour, the following sections look into the significant developments in the field of corporate governance principles and practices.

2.1.4 Corporate Governance Principles and Practices

The issue of corporate governance has gained significance in the wake of corporate failures. As a result, many apex bodies and institutions have proposed sets of good corporate governance practices and principles. The following section provides details of these developments.

Code of Best Practice - Cadbury Committee

The Cadbury Committee was set up in May 1991 in the wake of the failure of several big companies. The committee's report addressed various issues such as board effectiveness, board structures and procedures, standards of conduct, the effectiveness and value of audits, and accountability towards shareholders. The report averred that good corporate governance is vital for the growth of business and for gaining and maintaining investor confidence (Cadbury, 1992).

The major recommendations (the code) issued by the Committee focused on the role of boards of directors and auditors with specific attention to *'financial reporting and accountability'*. The report recommended that the board should meet regularly, retain full and effective control over the company and monitor the executive management. It was further recommended that selection of non-executive directors should be impartial and that a majority of non-executive directors should be independent of the company. The report stated that the board is responsible for presenting a balanced and understandable assessment of the company (Cadbury, 1992). The recommendations made by the Committee were in the form of structural changes and rules.

According to the Committee the *".......Code of Best Practice [is] designed to achieve the necessary high standards of corporate behaviour [sic]"* (Cadbury, 1992). However, the emphasis of the Code was on structure rather than on behaviour. But the significance of understanding behavioural issues was apparent in the report: *"Raising standards of corporate governance cannot be achieved by structures and rules alone. They are important because they provide a framework which will encourage and support good governance, but what counts is the way in which they are put to use."* (Cadbury, 1992). The report established the importance of structural measures, but also suggested the need to understand the behavioural issues by raising the concern that statutory measures require a minimum standard and could result in *'compliance with the letter, rather than with the spirit'* of standard measures (Cadbury, 1992).

The Code of Best Practice by the Cadbury Committee was followed by a series of developments such as issuance of The Combined Code on Corporate Governance (2003, 2006 and 2008) and The UK Corporate Governance Code (2010, 2012, 2014 and 2016) (*European Corporate Governance Institute*; *The UK Corporate Governance Code*, 2016). Despite a series of developments, the nature of corporate governance is "*... limited to being a guide only in general terms to principles, structure and processes. It cannot guarantee effective board behaviour..."(The UK Corporate Governance Code, 2012).*

The UK Corporate Governance Code (2016) states that "One of the key roles for the board includes establishing the culture, values and ethics of the company .... The directors should lead by example and ensure that good standards of behaviour....". However, the code mainly provided for structural issues such as division of responsibilities, board composition and the selection process. transparency in board operations, director remuneration etc. (The UK Corporate Governance Code, 2016).

Principles of Corporate Governance - OECD

The OECD Principles of Corporate Governance were first issued in 1999 and later revised in 2004 and 2015. The principles of corporate governance provided by the OECD form the basis for corporate governance initiatives in both OECD and non-OECD countries. The initial focus of these principles was on providing a transparent corporate governance framework, ensuring a division of responsibilities among different supervisory. regulatory and enforcement authorities, facilitating protection of shareholders' rights, encouraging active co-operation between corporations and stakeholders and ensuring timely and accurate disclosure on all material matters (OECD, 2004). The revised principles (2015) raise some behavioural issues such as the role of regulatory authorities in detecting dishonest corporate behaviour, freedom for shareholders and employees to raise issues of illegal and unethical behaviour, boards' duty of loyalty towards the company and management of conflicts of interest.

However the primary focus of these principles remains *on "supporting economic efficiency, sustainable growth and financial stability"* (OECD, 2015). These principles are driven by *"the increasing complexity of the investment chain, the changing role of stock exchanges and the emergence of new investors, investment strategies and trading practices"* (*G20/OECD Principles of Corporate Governance*). The corporate governance principles of the OECD are revised to meet the changing requirements, but in terms of behavioural aspects these principles have not provided any insights other than admitting the importance of behavioural issues in providing good corporate governance.

The Sarbanes Oxley Act

The Sarbanes Oxley Act (2002) brought significant changes for the US companies. The objective of the Act was to *"to restore shareholder trust in the stock markets by improving the reliability and accuracy of the financial reports"* (Sneller & Langendijk, 2007). The Act primarily focused on the financial aspects and requires all the listed companies to have audit committees formed by independent directors only. The Act also forbids the external auditors of a company from providing any type of non-audit or consultancy services to the company (Romano, 2004). In this way, the Act brought changes to control any conflicts of interests affecting the reliability of the financial statements.

Some of the other changes under the Act have also had a significant impact on the practices of companies. For example, the Act prohibits companies from providing any type of credit or loan facility to its executives or directors. The Act also requires the CEO and CFO of a company to certify the financial statements of the company in terms of fair presentation of the financial results of the company (Romano, 2004). The power to appoint external auditors is also given to the audit committee, and the management or board of the company is not involved in the process. Moreover, the external auditors are required to rotate their assigned employees for every company they audit. These changes were to ensure that the auditors do not develop a personal relation with the client company (Clark, 2005). The changes brought under the Act are primarily focused on improving the reliability of the financial statements of a company, and the Act is silent about the behavioural aspects of corporate governance.

Corporate Governance Principles and Guidelines - The Securities Commisssion New Zealand

This set of principles was set out in a report by the Securities Commission, New Zealand in the year 2004. The principles are intended to contribute to high standards of corporate governance in New Zealand entities and provide recommendations on board composition (in terms of the balance of independence, skills, knowledge, and experience), the use of committees by the board (to improve operational effectiveness), integrity, both in financial reporting and in the timely, transparent, fair and reasonable remuneration of directors and executives, the quality and independence of the external audit process, and constructive relationships with shareholders (*Corporate Governance in New Zealand: Principles and Guidelines*, 2004) .

The focus of these principles is on "……. reporting and disclosure of corporate governance structure and processes, as well as on reporting of financial and other material matters" (Corporate Governance in New Zealand: Principles and Guidelines, 2004). These principles were revised in 2014 to reflect on the ethical behaviour of boards, the reporting of performance based on diversity, the use of committees to complement corporate governance structure, changes in accounting standards and a risk management framework (FMA, 2014).

ASX Corporate Governance Principles and Recommendations

In Australia, the ASX Council established corporate governance principles and recommendations in 2003 which were later revised in 2007 and 2010. The principles require the companies to clearly establish and disclose the roles of its board of directors and the management, and the basis for monitoring and evaluating their performance. The principles also recommend that the companies have a board of an "appropriate size, composition, skills and commitment", who should act ethically and adhere to the code of conduct of the company. The companies are also recommended to follow rigorous processes for ensuring the reliability of financial reporting, and to provide timely and adequate disclosure of material information. The companies are also advised to provide adequate remuneration to their boards of directors and other executives so as to attract experienced and quality people (*Corporate Governance Principles and Recommendations*, 2014).

As discussed above, the ASX principles mainly provide guidance in relation to the board composition, and other governance practices, even though the principles do not relate to the behavioural aspects of corporate governance, but are based on the premises that corporate governance is a dynamic concept that is affected by the corporate culture prevalent in an organisation (*Corporate Governance Principles and Recommendations*, 2014).

Review of Corporate Governance Principles and Practices

The principles and guidelines by various bodies given above mainly focus on the structural aspects of corporate governance. The recommendations in all the above primarily focus on improving the structural elements of the corporate governance process and highlight the need to improve board composition (to have board members from areas of wider experience), the use of board committees with primary responsibility to the board (to improve operational efficiency), transparency in reporting and division of responsibility.

There is hardly any mention of the decision making aspects of boards or related processes. Even though the revised versions of some of these principles accept the importance of behavioural aspects of corporate governance, there are no guidelines or recommendations to monitor/guide/analyse the actual behaviour or decision making processes. Keeping in mind the significance of board behaviour, *"it is important to place as much emphasis on board behaviour as is placed on board structure if an overall system of corporate governance is to be attained" (Okoye, 2015).* Sharpe (2011) and Plessis (2008) also criticise the regulatory reforms for their primary focus on board composition and structure, and for ignoring the processual and behavioural aspects of corporate governance. On a similar note (Carver, 2007) states that the code of best practice fails to address the real governance issues. Marnet (2004) has also observed that the "conventional proposals to reform corporate governance through legislation, codes of best practice, and the like, are necessary, but underestimate the pressures which reputational intermediaries face from inevitable conflicts of interest and bias". The author calls for an attention towards the behavioural components of corporate governance.

These new reforms are also questioned by Leblanc and Gillies (2005, p. 23), who state that despite the increased regulations, large and established corporations have failed which indicates that the new reforms have not made a significant difference. According to the authors there is still a need to understand how boards actually take decisions (Leblanc & Gillies, 2005, p. 104). Steckler and Clark (2018) observe that the "regulations and other external mandates have come to be viewed as necessary pre-emptive or intervening functions of governance; however, these have proven insufficient for ensuring improvements in accountability, transparency, or ethical decision making".

Further, recent literature identifies issues such as "ceremonial adoption" of regulations as a symbolic gesture of compliance (Shi & Connelly, 2018). For example appointing someone with vested interest in the organisation as an independent director. When the firms adopt certain corporate governance practices in response to the pressure of regulations, there is a possibility of decoupling prescriptive norms from actual operations (Bromley & Powell, 2012; Hambrick & Lovelace, 2018; Markóczy, Li Sun, Peng, Shi, & Ren, 2013), which according to Shi and Connelly (2018) is a symbolic management gesture similar to "ceremonial adoption". It is a challenge to directly observe whether or not a certain practice is a ceremonial adoption. However, inferences can be drawn by observing the changes that result after the adoption of a certain practice or norm that can help identify if a practice is ceremonial Shi and Connelly (2018). According to Aguilera, Judge, and Terjesen (2018) organisations may deviate from corporate governance practices by underconforming or overconforming governance practices. The authors state that the deviant behaviour is contingent on the regulatory environment (degree of consistency in monitoring, and the severity of punishment) and the corporate governance capacity (financial, human, moral and social capital) of the firm. The literature have addressed the contingencies related to the regulatory environment; however the concept of corporate governance capacity has not been duly addressed in context of human, moral and social capital.

It can be concluded based on previous discussion that the behavioural perspective of corporate governance has been absent from most of the research on corporate governance, and that there is an increase in current research to further analyse and develop these practices. It has also been found that there is lack of an established behavioural model to study the behavioural perspectives. Since this research focused on behaviourally plausible decision centred perspectives on the role of corporate governance, it was essential to choose a fundamental basis/theory to pursue the research further. The following section provides further details on that.

2.1.5 Behavioural Perspectives and Decision Paradigms

Since the literature on corporate governance decision making is extensive (Huse et al., 2011), here the objective was to select a theoretical base to facilitate the analysis of corporate governance decision making through behavioural perspectives. In a significant research Eisenhardt and Zbaracki (1992) conducted an extensive literature review and identified three modes of organisational decision making that included Rationality and Bounded Rationality, Politics and Power and Garbage Can. The authors identified that there are cognitive limits that affect the rationality of decision makers who aim to reach a satisfactory decision rather than an optimum decision. In terms of Politics and Power the authors state that organisations consist of different people who have conflicting goals, and that the conflict is resolved through politics and power. The Garbage Can mode refers to the organisation as an ambiguous place with poorly defined decision preferences (Eisenhardt & Zbaracki, 1992). Similarly, Choo (2001) has identified four core modes of organisational decision making that include Bounded Rationality, Processes (clarity of strategic goals but not of procedures to attain them), Political, and Anarchic (lack of clarity on goals and procedures).

Smallman and Moore (2010) conducted a review of decision making theory and have provided six paradigms. The first is the classical concept of prescriptive, analytical decision making, which states that decision makers collect and analyse information in order to select an optimal solution. However, there is a subjective expectation that affects the choice of an optimum solution. The second paradigm, which is more realistic than the first, is Bounded Rationality, which assumes constraints on rational decision making. According to the authors there is enough evidence to suggest that both these paradigms fail to address the mediating process related to decision making. The third is the contingent or adaptive view of decision making that facilitates natural dynamics in problem solving. The Political paradigm refers to the role of power and politics in resolving issues among the members of the organisation. The fifth paradigm represents the pragmatic aspect of decision making that attaches great significance to the context of decision making. Naturalistic decision making is the sixth paradigm which relates to the study of real decision situations, mainly in highly risky and volatile environments (Smallman & Moore, 2010).

The literature presented a wide range of theories to choose from. Here the selection was guided by the primary aim of this research, which is to provide a behaviourally plausible decision centred perspective of corporate governance. Analysis of the different theoretical bases identified by Smallman and Moore (2010), Choo (2001), and Eisenhardt and Zbaracki (1992) made it apparent that *A Behavioral Theory of the Firm* is the appropriate choice. The choice was further confirmed by Ees et al. (2009), who state that most of the decision making concepts used to capture the behavioural dynamics of boardroom can be traced back to the pioneer work of Cyert and March- *A Behavioral Theory of the Firm,* which was first published in 1963. According to Luoma (2016), the distinctiveness of *A Behavioral Theory of the Firm* lies in its behavioural realism that links the decision model closely to empirical observations. Earlier, Huber and McDaniel (1986) stated that the Carnegie School led the field of organisational decision making, and its pioneer work *A Behavioral Theory of the Firm* is used as the basis of many process oriented studies. Similarly, Greve (2015) notes that there is an increase in the use of *A Behavioral Theory of the Firm* as a theoretical foundation while some other theories are losing prominence in the field of decision making. Huse et al. (2011) further support the selection of *A Behavioral Theory of the Firm* for the purpose of this research. They refer to the theory as a natural starting point for exploring the behavioural aspects of corporate governance. The following section discusses the theoretical significance of the theory, which further affirms the choice of the theory for this research.

Theoretical Legacy of A Behavioral Theory of the Firm

A Behavioral Theory of the Firm has greatly influenced modern research on decision making (Gavetti, Greve, Levinthal, & Ocasio, 2012). On 09 November 2016, a search on *Google Scholar* provided *22,380* citations for *A Behavioral Theory of the Firm,* which indicate the influence the theory has on decision making research. Moreover, in 2007, a well-recognised journal, *Organization Science (Volume 18 -3),* published a special issue dedicated to this contribution by Cyert and March. *A Behavioral Theory of the Firm* was originally published in 1963, and according to Argote and Greve (2007) is one of the most influential management books of all time, which has "*inspired and legitimated new approaches for studying organizations; become a foundational element of* *organisational studies in management, economics, political science, and sociology"*. However, the particular influence of this theory is on evolutionary economics and organisational learning (Argote & Greve, 2007; Gavetti et al., 2012).

However Argote and Greve (2007) note that the book has not generated a theory in terms of "a consistent set of defined concepts and assumptions" and derived causal predictions. It has resulted in many different theories that are derived on the basis of different assumptions and predictions. It could be that Cyert and March predicted this outcome and have named it A (not "The") Behavioural Theory of the Firm (Argote & Greve, 2007).

The theory has inspired and influenced several diverse research traditions that are quite different from the original theory. However, *A Behavioral Theory of the Firm* has offered a common ground that connects the foundations of the theories that followed it. In a way, *"the book has been essential for developing a field where diversity coexists with a fruitful dialogue between perspectives"* and *"these conditions have helped the field of organizational science to make rapid progress"* (Argote & Greve, 2007). However, Gavetti, Levinthal, and Ocasio (2007) state that the research that followed the Carnegie tradition has shifted away from the organisational level of analysis and decision making with most focusing on the organisational environment, organisational learning, adaptation and change.

A Behavioral Theory of the Firm has focused on four research commitments that are quite relevant and important for the current research. These include "1. Focus on a small number of key economic decisions made by the firm ………… 2. Develop process-oriented models of the firm ……. 3. Link models of the firm as closely as possible to empirical observations …... 4. Develop a theory with generality beyond the specific firms studied". The first and fourth commitments of the theory are closely related to economics, but the second and third have become milestones in studying organisational behaviour, and are common conventions in the field of organisation research (Argote & Greve, 2007). On the other hand Gavetti et al. (2007) have identified four theoretical pillars of the Carnegie School, that include Bounded Rationality, Specialised Decision making- Structures, Conflicting Interest and Cooperation and Routine Based Behaviour and Learning. Out of the four pillars, bounded rationality has a significant impact on the following research (Gavetti et al., 2007).

The Attention-based view to organisational decision making also links back to *A Behavioral Theory of the Firm* and the underlying concept of bounded rationality. Ocasio (1997) defines attention as noticing, encoding, interpreting, and focusing of time and efforts by the decision makers in terms of the problems and solutions. According to the Attention-based view, the attention of the decision maker is a critical element of the information processing ability of the organisations (Joseph & Wilson, 2017; Ocasio, Laamanen, & Vaara, 2018).

A Behavioral Theory of the Firm has theoretically influenced many theories (Argote & Greve, 2007; Gavetti et al., 2007); however the main legacy of the book is that *these "theoretical advances have found their way into the foundation of many other theories, where they have been combined with new concepts and mechanisms to produce new theory"*. In a way, the theory has resulted in a chain of research commitments and contributions. However, the theory's weakness lies in the quantitative testing of the main propositions of the theory, probably due to the lack of rigorous testing methods at that time. Though the propositions related to the theory were not tested rigorously, the book was ahead of its times in terms of its contributions (Argote & Greve, 2007).

Gavetti et al. (2007), took a broader perspective and conducted a review of the Carnegie School. They state that *"the School's creation of a constellation of closely related ideas rather than a narrow paradigm with strong closure properties has certainly helped it to flower and spread".* But the influence of the School has been broad rather than deep, and many researchers have selectively paid attention to some of the aspects while ignoring others. However, they note that the School still plays an influential role in current research though in selective and fragmented forms (Gavetti et al., 2007).

Gavetti et al. (2012) assessed *A Behavioral Theory of the Firm* in the current context and stated that, although much of the theory proposed in 1963 is still relevant today, some original foundations of the theory have been revised in terms of current developments. The first shift is from standard operating procedures to routines, where the researchers are focusing on habitual actions rather than standard operating procedures based on bounded rationality. The second change is from expectations to representations, as decision choices are not only perceived as a reaction to short-run feedback, but rather, some important decisions could be the result of deliberate attempts on the part of the organisation to anticipate the future. The third is related to performance feedback, which refers to the concept of a Problemistic search. The basic proposition of *A Behavioral Theory of the Firm* was that performance below aspiration levels results in a search for solutions. Current research validates this concept but also observes that the rate of change in the organisation will depend on whether the performance is below or above the aspired levels (relative performance). It also relates organisational change to its problems, which provides a broader foundation to research on organisational learning and adaptation (Gavetti et al., 2012).

According to Kim and Rhee (2017), relative performance is a behavioural consequence and is relative to a reference point. They further state that the structural position of the decision makers is the key factor affecting divergent behaviour. Further, according to Kacperczyk, Beckman, and Moliterno (2015) *A Behavioral Theory of the Firm* relates to the organisational problems/concerns, and does not address the individual level problems/concerns. According to the authors, organisational change is the outcome of organisational problems/concerns, whereas risk arises as the outcome of individual concerns. There is a need to study the role of individual determinates of risk in context to the organisational determinants of risk (Kacperczyk et al., 2015).

It has also been observed that the proposition that an organisation is a political coalition has not developed into a separate distinctive theory, but has influenced the research in the field of organisation strategy and circulation of power, with a major focus on inter relationships. In terms of learning and adaptation *A Behavioral Theory of the Firm* focused on adaptation in attention rules and adaptation in search rules, whereas of late learning from the external environment has been considered a significant factor (Gavetti et al., 2012).

A Behavioral Theory of the Firm - The Carnegie School

The Carnegie School belongs to the Carnegie Mellon University where the leading contributors worked during the initial research on behavioural theory (Luoma, 2016). *A Behavioral Theory of the Firm* is one of the prime contributions of this school. The theory assumes *" the firm as its basic unit,… the prediction of firm behaviour with respect to such decisions as price, output, and resource allocation as its objective, and … and explicit emphasis on the actual process of organizational decision making as its basic research commitment"* (Cyert & March, 2001, p. 19).

The theory does not assume a single, universal goal, and emphasises that objectives and goals vary within the same organisation. For instance, the goal of one individual may be different from another in the same way as the goal of one department or sub unit may not be same as the other one. Organisational goals change with the entry or exit of a coalition member. The aspiration level, which is the function of past performance, also affects the organisational goals. The theory states that variation and conflict among the goals leads to bargaining among the members, which results in formation of the goals of the organisation. The limited bargaining power of the individuals affects the bargaining process, however, past bargaining experience forms the ground for the present situations. The goals/demand of individual members may change with experience and time. The availability of resources also plays a significant role. If the resources are adequate to meet the demands of all the members, the coalition functions feasibly (Cyert & March, 2001).

Since the organisation as a coalition of members faces a series of member driven goals, it needs to allocate resources, the decision for which depends on the availability of information and internal expectations of the organisation. In its search for information the organisation does not focus on consistency or completeness of information, and no constant rules of search are followed. The search for information is mainly driven by situations where existing decisions do not fit. The search for information is unsystematic, bounded and driven by problems. In most cases a firm's commitment to an action occurs in the very early stages of the search. The decision making is biased due to the bias in organisational expectations and communication processes. The members of the coalition may alter their communication priorities in view of the consequences attached to that piece of information (Cyert & March, 2001).

The theory states that decision choices and control are affected by the sequential consideration of alternatives, where the first suitable alternative is accepted and the search is abandoned. Only if a selected alternative fails to deliver the expected results is a new search is started. To deal with uncertainty, an organisation responds and reacts to the feedback and does not indulge in forecasting the environment. Organisations induce stability by using standard operating procedures and simple rules that are based on the past experiences (Cyert & March, 2001).

A Behavioral Theory of the Firm is based on four relational concepts, which represent the four sub-processes of decision making. The following Figure presents and illustrates these concepts.

Figure 2.1 Organisational Decision Making Process as adapted from Cyert and March (2001, p. 175)

Image removed for Copyright compliance

The above figure presents the interaction and connectivity among the four sub processes of organisational decision making. However, it does not present the behavioural consequences of these sub processes. The following section discusses the four sub-processes in detail.

1. **Quasi resolution of conflict**: Similarly, to other organisational theories, *A Behavioral Theory of the Firm* assumes that an organisation is a coalition of members who have different goals. The difference in goals leads to conflict among members and organisations are required to adopt some procedures to resolve that conflict. However, the procedures will not result in a common goal of the organisation. The theory takes goals as independent constraints imposed by the members of the organisation and the conflict is resolved through local rationality, acceptable-level decision rules, and sequential attention to goals. The concept of local rationality assumes that individual members/subunits deal with a limited set of problems and goals. Acceptable-level decision rules and sequential attention to goals bring consistency to decision making (Cyert & March, 2001, pp. 164-166).

2. **Uncertainty avoidance**: Uncertainty is an integral part of organisational decision making. Organisations have no choice but to sustain the uncertainty arising out of various environmental factors. This has greatly influenced decision making theory, which mainly focuses on problems and issues related to uncertainty and risk. According to *A Behavioral Theory of the Firm,* organisations do not design strategies to deal with uncertainty but rather they avoid uncertainty. Organisations prefer to focus on short-run feedback rather than

anticipating the long run consequences. Organisations also negotiate with the external environment to avoid uncertain situations. The basic approach is to adapt *Feedback-react decision rules,* where a problem is resolved as it arises, thereby solving the problems in a series (Cyert & March, 2001, pp. 166-168).

3. **Problemistic search**: The search for a solution to the problem is driven by the problem itself. It is different from a search from random curiosity and for developing an understanding but is motivated by a problem which arises when the organisation fails or expects to fail in achieving its goals. The search continues till a solution is found for the problem. The solution could be in the form of an alternative to achieve the goals, or sometimes the goals are revised to match the available alternative. However, the search is simple minded and carried out in the neighbourhood of the current problem or existing alternative. There is bias in the search which arises from differences in training, experience, expectations and information access (communication bias) within the organisation (Cyert & March, 2001, pp. 169-171). The problemistic search by the organisation is related to the problems faced by the organisations and the related solution. According to the Attention-based view, decision makers could be selective/biased in terms of their attention structure and pay specialised attention to certain aspects (Joseph & Wilson, 2017). The work cited by Hallen and Pahnke (2016) and Van Knippenberg, Dahlander, Haas, and George (2015) supports that the information search by the decision makers is limited in terms of their ability to access, attend and process information or economising of efforts due to large number of decisions.

4. **Organizational learning**: Similarly, to the individual, organisations learn and adapt their behaviour time. The adaptation happens in three different phases that include adaptation of goals, adaptation in attention rules, and adaptation in search rules. Organisation goals are in the form of aspiration levels which change with the experience of the organisation or that of similar organisations. With time, organisations also learn to pay attention to some parts of the environment and ignore other parts. Since the search is problem oriented, it is assumed that search rules also change with time. The experiences of an organisation will alter the way it searches for solutions, or will change the order in which various solutions to a problem are considered (Cyert & March, 2001, pp. 171-174). According to Hu, He, Blettner, and Bettis (2017),and (Nason, Bacq, & Gras, 2018) the adaptation and learning from feedback is based on economic/historic references and/or social references.

Values as Drivers of Behaviour

The previous sections have established the need for further research into the behavioural aspects of corporate governance. This section aims to further explore and narrow down the concept of behaviour for the purpose of this research. Different studies have linked decision making behaviour to different factors. For example, a review of literature by (Harrison & Murray, 2012) indicates that personal qualities of the leader affect his decision behaviour, whereas Minichilli et al. (2007) relate board room decision making to the culture, trust and emotions of the decision makers. Lipman-Blueman (2005, pp. 21-22) relates the destructive behaviour (with conscious or unconscious engagement) of top leaders to dysfunctional personal characteristics. Research by Erickson, Shaw, and Agabe (2007) relates the decision making behaviours to the ethics and competencies of leaders.

What all the above researchers seem to follow is the Trait Approach that relates effective leadership to the personal characteristics and abilities of the leader. The Trait Approach provides that effective and successful leaders possess certain traits; however, possession of those traits does not necessarily lead to effective leadership (Erickson et al., 2007). While the Trait Approach relates decision behaviour to the inner self of the decision maker, the Contingency Approach suggests that leadership behaviour is a function of context and situations (Fiedler, 1972). On the basis of the empirical literature review of decision making literature, Ford and Richardson (1994) recognise the above two as the basic approaches to studying decision behaviours. They divide the variables affecting decision behaviour into individual factors (traits) and situational factors (context). This research is based on the individual factor approach as it explores the behavioural perspectives related to individual decision makers. The objective here is to analyse the factors associated with the decision makers, as context has an external locus of control.

In terms of individual factors, a growing body of literature considers the values of the decision maker to be an important factor to study decision behaviour (Ford & Richardson, 1994; Fritzsche & Oz, 2007; Groot & Steg, 2008; Hemingway & Maclagan, 2004; Mumford, Helton, Decker, Connelly, & Van Doorn, 2003; Reed, Vidaver-Cohen, & Colwell, 2011; Rohan, 2000; Schwartz, 2016; Tagiuri, 1965). According to Suar and Khuntia (2010), values are an intrinsic determinant of human behaviour and are the *"prime driver of personal, social and professional choices"*. As per Groot and Steg (2008) values play a significant role in shaping behaviour. On a similar note, Guth and Tagiuri (1965), state that *"consciously or unconsciously, personal values are one of the determinants of the manager's concept of what his company's strategy ought to be"*. Similarly, values are considered to influence people in their perception and interpretation of decision situations, thereby affecting their decisions, choices and behaviours (Gandal, Roccas, Sagiv, & Wrzesniewski, 2005). According to Licht (2001) values guide the selection or evaluation of behaviour, people, and events.

For Schwartz (2009) and Schwartz (1992), values are the beliefs about desirable goals, that transcend specific actions and situations, serve as a standard and vary in relative importance. According to Rokeach (1973, p. 5), *"A value is an enduring belief that a specific mode of conduct or end state of* *existence is personally or socially preferable to an opposite or converse mode of conduct or end-state of existence"*. Both Schwartz and Rokeach define values as beliefs that are related to desirable goals and act as evaluating standards. Values are also considered to be a *"conception of the desirable which orient toward action"* (Bengtson & Lovejoy, 1973), and as a *"permanent perceptual framework which shapes and influences the general nature of an individual's behaviour"* (England, 1967).

Considering the above literature, this research assumes values to be the drivers of behaviour. For the purpose of this research values are defined as the conception of the desirable, on the basis of which selection from available alternatives is made. The choice of values as the drivers of behaviour is justified by Roccas, Sagiv, Schwartz, and Knafo (2002) as they state that " traits describe what people are like rather than the intentions behind their behaviour. Values refer to what people consider important, the goals they wish to pursue".

2.2 Corporate Failure

2.2.1 Defining Corporate Failure

This section aims to define the concept of corporate failure. According to Mellahi and Wilinson (2004) there is lack of consensus in the literature on defining corporate failure (Cohen et al., 2010). Amankwah-Amoah (2016) defines corporate failure as discontinuance of a business or its ownership. It is also referred to as *"a stage when an organisation ceases operation, loses its corporate identity, loses the capacity to govern itself"* (Hager, Galaskiewicz, Bielefeld, & Pins, 1996). Marks and Vansteenkiste (2008) also consider ccorporate failure as an absolute end of an organisation but they provide a broader opinion on that. They state that corporate failure is "*when an entire company goes out of business or a plant, office, or other unit is closed. Second is the effective end of an organization's activities, community, and culture when an entity is acquired by and integrated into another firm or when a department or business unit is dissolved through an internal restructuring"* (Marks & Vansteenkiste, 2008).

On the other hand, some authors do not consider failure to be the end of an organisation. For example, Mellahi and Wilkinson (2010) propose that *"an organization fails when its ability to compete deteriorates as a consequence of actual or anticipated performance below a critical threshold that threatens its viability"*. Where Amankwah-Amoah (2016) consider failure as an absolute end of an organisation, Mellahi and Wilkinson (2010) propose that an organisation may continue with a failing performance. However Anheier (1999, p. 276) recognise that corporate failure can fall into any of these categories, and states that organisational failure *"can be the absolute end, or dissolution, of a firm. However, it can also lead to persistently low performance or profound reorganisation".* The author further states that the literature classifies corporate failure into two types: Transformation and Closure. Transformation refers to merger, loss of independent control, and change of ownership. Closure denotes bankruptcy, and loss of corporate charter (Anheier, 1999, p. 276).

On the other side Gillespie and Dietz (2009) define corporate failure *as "a single major incident, or cumulative series of incidents, resulting from the action (or inaction) of organizational agents that threatens the legitimacy of the organization and has the potential to harm the well-being of one or more of the organization's stakeholders"*. In defining corporate failure Gillespie and Dietz (2009) assume that corporate failure has an internal locus of control even though external factors and the environment may form the context.

For the purpose of this research corporate failure is considered to be the end of the organisation in the form of liquidation (not voluntary) or bankruptcy. The research aimed to analyse what Lane (2016) termed an "Unexpected failure". Hence it analysed the failure of companies, which were supposed to be performing well (in disclosure statements) and whose end was largely unexpected in the years preceding failure. The research also assumed failure as a series of incidents, with an internal locus of control (Gillespie & Dietz, 2009). The concept of an inner locus of control, which is called an inner context by Pye and Pettigrew (2005), is also supported by Huse (2005) who considers corporate governance decision makers to be an important aspect of corporate governance.

2.2.2 Corporate Failure Research - Trends and Perspectives

Corporate failures over the last two decades have motivated many researchers to analyse corporate failures. For example, in June 2005, the renowned journal, *Long Range Planning* (Volume 38 - 3) published a special issue focusing on organisational failure. The central theme was to look into the causes and processes of organizational failures and the learning from failures. This was followed by a special issue of *Group and Organisation Management* (Volume 35-5), which was published in 2010. The central theme of this issue was managing and coping with organisation failure.

According to Mellahi and Wilkinson (2010), there has been a call for more research in the field of corporate failures by scholars from various disciplines such as business management, strategic management, business history, economics, and political science and law. On a similar note Hamilton (2006), states that most of the organisational research analyses the birth and growth of organisations, whereas the decline and death of organisations are less explored aspects.

Amankwah-Amoah (2016) states that research on corporate failures is categorised between deterministic and voluntarist perspectives. The deterministic perspective assumes that managers and leaders are powerless and have no control over the impact of a changing environment. The voluntaristic perspective, driven from organisation psychology literature, assumes that organisational failure is fundamentally related to the actions/inactions and perceptions of the managers (Amankwah-Amoah, 2016). Similarly, Mellahi, Jackson, and Sparks (2002), provided the Industrial Organisation perspective and the Organisational Studies perspective. The Industrial Organisation perspective, similarly to the deterministic perspective, considers managers of failing organisation to be the victims of the external environment with no control over that. This perspective states that organisation failure does not necessarily mean ineffective or inefficient management. Whereas, according to the Organisational Studies perspective, failure has an internal locus of control, and is related to the ineffective management (Mellahi et al., 2002). This research has analysed corporate failures from the voluntaristic perspective through a behavioural lens, with a focus on decision makers.

2.2.3 Corporate Failure - Theoretical Perspective

Pioneer work by Shrivastava, Mitroff, Miller, and Miclani (1988) has provided a model of industrial crisis (failure) that depicts the stages in corporate failure. The model assumes that an organisational crisis is triggered by specific events that can be identified according to place, time and participants. These specific events are termed triggering events and are preceded by warning signals (Shrivastava et al., 1988). If the warnings are not duly addressed during the incubation period (Turner, 1976), they lead to failure. The failure results in extensive damage, and with time, affected stakeholders recover from the crisis. However, the recovery does not necessarily imply elimination of the causes of failure.

Turner (1976), presents six stages of corporate failure, which he termed failure of foresight. Stage one is notionally the normal stage where set rules and norms are adhered to. The second stage is the incubation stage, during which issues/events at odds with established rules and norms go unnoticed and accumulate. In the third stage, a precipitating event attracts attention due to its immediate effect. The precipitating event leads to stage four which comprises the onset of unanticipated consequences. In stage five actions are taken to resolve the immediate effects of the event, and in stage six rules, norms, beliefs are adjusted as per the newly learned experience of failure (Turner, 1976).

The model of corporate failure by Weitzel and Jonsson (1989) consists of five stages. In the first stage the organization is blind to the early signs of failure. In the second stage the organisation, though it recognises the need for change, fails to act. An action is taken in the third stage but the action is not a suitable option for the existing problem, which leads to the fourth stage of crisis, followed by the fifth stage of dissolution (Weitzel & Jonsson, 1989). The models proposed by Turner (1976), Shrivastava et al. (1988), and Weitzel and Jonsson (1989), although they vary in terms of the stages of failures, all agree that signs of failure exist in the very early stages (Drennan, 2004), which when ignored trigger failure.

A similar model was proposed by Stead and Smallman (1999), on the basis of the synthesis of corporate failure literature. According to the authors, corporate failure has five stages which include Pre-conditions, Trigger, Crisis, Recovery, and Learning. In the first stage of Pre-conditions, there exist established beliefs, precautionary norms, and a regulatory framework. Pre-conditions may arise out of an accumulated unnoticed set of events that are at odds with the established beliefs and norms about the problems and related measures (Stead & Smallman, 1999). According to Turner (1976), factors such as rigidities in institutional beliefs, decoy phenomena, neglecting outside complaints, information handling issues, failure to comply with relevant regulations, and rejection of emergent danger lead to pre-conditions to failure. Trigger is the 'precipitating event' (Turner, 1976) which is identifiable according to place, time and participants (Shrivastava et al., 1988). The triggering event is difficult to ignore but it often follows warning signals. The Crisis event follows the trigger, and represents the onset of the crisis, which will bring direct and indirect, anticipated and unanticipated consequences (Stead & Smallman, 1999). These consequences result in extensive damage (Shrivastava et al., 1988). After the crisis, the organisations try to limit the effects of the crisis in the recovery stage, so as to control the damage. Some initial adjustments are made for immediate rescue. The last stage of learning refers to the steps taken to avoid a further occurrence of similar events, leading to a shift in the beliefs of the organisation and precautionary norms. The above details on the models of corporate failure establish that corporate failure originates from pre-conditions or early warning signals that are often ignored by the failing organisations. This calls for further research in this context and this research is going to analyse corporate failures from the perspective of pre-conditions.

2.3 Research Gap and Chapter Summary

The chapter reviewed literature related to corporate governance and corporate failures, with additional focus on the decision making and behavioural aspects. In doing so, the chapter presented the rationale for using *A Behavioral Theory of the Firm,* to study the decision paradigm. Additionally, the chapter also presented Values as the drivers of behaviour.

The literature review has established that there is a gap in the present research in terms of the behavioural perspective on corporate governance (intervening processes), which is an evolving concept and is under explored. Moreover, literature also establishes that the response to corporate failures, in terms of theoretical and regulatory developments, lacks behavioural explanations, despite the evidence of the significance of behavioural elements. This calls for further research and is one of the areas to which this research aims to contribute. The thesis addresses this gap as it focuses on the behavioural aspects of corporate governance decision making in the context of corporate failures. Overall, the thesis addresses the following:

> *"What is the role of corporate governance in corporate failures? Does poor corporate governance lead to corporate failures? If so how?"*

To answer the above, and based on the literature review, this research aims to analyse the data related to corporate failures from the perspectives of corporate governance functions (inputs), decision processes and value orientation. Chapter 3 explains the method employed in this thesis to answer the above questions.

Chapter 3

Research Methods

The objective of this chapter is to provide an understanding of the research methods used by the researcher for the purpose of this research. Thereby, Section 3.1 provides the rationale for using qualitative research methods and justifies the adoption of the case study as the research strategy. The section also informs about the process of the selection of the sample cases (primary unit of analysis), with further details on the selection of the secondary unit of analysis. Section 3.2 provides details on data collection (including the justification for using secondary data) and Section 3.3 details the data analysis process. Additional details on data analysis are also provided in Chapter 6 so as to support the understanding of the findings. The last section of the chapter addresses the issue of reliability and validity.

3.1 Qualitative Approach

This research has adopted a qualitative approach to explore the role of corporate governance in corporate failures. It has been addressed in previous chapters that corporate governance research has been dominated by quantitative methods with little focus on board behaviour. This study uses a qualitative approach to present *A behaviourally plausible decision centred perspective on the role of corporate governance in corporate failures.* According to Levaru and Berghe, qualitative research is not only most suitable to look into the complex board behaviour issues, but it is advocated to “counter balance” the quantitative techniques usually used in board research (Levrau & Berghe, 2013).

A qualitative approach is an effective method for conducting social research and humanistic studies (Creswell, 2003; Robson & McCartan, 2016, p. 18). This research aims to explore the behavioural aspects of corporate governance decision making. Corporate governance is a social process (Letza et al., 2008), so a qualitative research approach was considered suitable.

Qualitative research facilitates explanatory inferences (Creswell, 2003; Huberman & Miles, 2002). It allows issues and ideas to emerge and does not suggest or indicate anything in advance (Creswell, 2003). Since this research focused on the lack of research regarding the behavioural aspects of corporate governance, it was appropriate to use a qualitative approach to explore these behavioural aspects. It was anticipated that new realities may emerge during data collection that may require changes in the research questions (Creswell, 2003).

3.1.1 Case Study Method

"Building theory from case studies is a research strategy that involves using one or more cases to create theoretical constructs, propositions and/or midrange theory from case-based, empirical evidence" (Eisenhardt, 1989b). A case study is a suitable research strategy in studying a complex social phenomenon and contemporary issues (with no control over behavioural events) in depth (Yin, 2009, pp. 4, 18). Work by Eisenhardt (1989b), Eisenhardt and Graebner (2007), and (Yin, 2009) establishes the importance and strengths of the case study method. According to Eisenhardt (1989b) case study research is "particularly well-suited to new research areas or research areas for which existing theory seems inadequate". One of the unique strengths of the case study is that it can consider a full variety of evidence including documents, artefacts, interviews, observations etc. (Yin, 2009, p. 11). The case study has been the appropriate strategy for this research as a variety of documented sources including newspaper articles, journal articles, legal proceedings, court documents, books, public enquiry reports, and media reports have been used.

According to Yin (2009, pp. 8-9) a case study is suitable for research studies that focus on research questions consisting of "what" (exploratory nature only), "how" and "why" components. A case study also offers valuable *"insights into the nature of the phenomenon"* (Easton, 2010). This indicates the appropriateness of a case study strategy for this research, which aims to explore the behavioural aspects of corporate governance decision making. On a further note, a case study is also a suitable approach to study complex board processes (Nicholson & Kiel, 2007).

Selection of Cases (Sample)

The selection of the case study organisations was a critical element in the research proposal for this study. There were two issues to decide on, firstly the approach to select the case study organisations (sample) and secondly the number of case organisations.

Random sampling has been widely used in research, owing to its ability to generalise the results back to the population. This random sampling technique was not deemed suitable (Eisenhardt, 1989b) for this study because *"studying a random sample provides the best opportunity to generalise the results to the population but is not the most effective way of developing an understanding of complex issues relating to human behavior"* (Marshall, 1996). According to Marshall, qualitative studies can be based on a convenience sample, a judgement/purposeful sample or a theoretical sample. Though an element of convenience is present in most of the qualitative research, the author recommends the use of other thoughtful sampling techniques. Therefore, for the purpose of this research, the first consideration was to make a selection between a judgement/purposeful sample and a theoretical sample. A theoretical sample was not relevant to the research, owing to the lack of research/theory to explain the selected phenomenon. However, a purposeful sample was found to be the appropriate choice, as it allowed selection of a sample that could potentially answer the research questions (Marshall, 1996).

The first judgement criteria were the availability of and access to data. The study of board processes such as decision-making posits a big challenge, especially due to the availability and accessibility of data (Mellahi, 2005). It was necessary to make a purposeful selection to ensure that there was no dearth of data. The Enron Corporation was selected as the first case study because of the availability and quantity of data. Enron was a US-based multinational company that went bankrupt in 2001. It was once considered the most innovative and successful company in America, winning awards and accolades before going bankrupt (Downes & Russ, 2005). Post-failure Enron was subjected to many public inquiries and court cases and commentary. Any public inquiry into the failure of an organisation is an important source of information, which compensates for the lack of direct access to boardroom data (Mellahi, 2005). Enron's story has been covered in detail by many newspapers, magazines, research journals and books. Many of these publications used first-hand details from the people closely associated with Enron. Thus the purposeful selection of Enron ensured that sufficient data was available to provide compelling and detailed insights into the "chosen phenomenon" (Collins, Onwuegbuzie, & Jiao, 2006, p. 230; Patton, 2015).

Moreover, the failure of Enron has been studied from different angles (other than behavioural) such as quantitative/financial factors, board composition etc. This provided an opportunity to fill a research gap to study the failure of Enron from a new (behavioural and qualitative) perspective.

The second issue regarding case selection was the number of cases to be studied. This decision was important for the external validity of the research findings. To validate the findings of the study, replication logic was used (Rowley, 2002; Yin, 2009). The study adopted a replication approach with multiple case studies where *"each individual case study consisted of a "whole" study, in which convergent evidence was sought regarding the facts and conclusions of the case; each case's conclusions were then considered to be the information needing replication by another case"* (Yin, 2009). Following the advice of Rowley (2002); Yin (2009, p. 61) this research uses the findings from two case organisations.

The second case organisation selected for the purpose of this research was Nathans Finance Ltd. Nathans was formed in July 2001 as a wholly owned subsidiary of a vending technology company - VTL Limited. The company went bankrupt in 2007 (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011). Nathans was carefully selected to facilitate the application of replication logic and presented an opportunity for possible contrasting replication (Yin, 2009, p. 54) as it was a smaller company compared to Enron. Also, a preliminary research related to Nathans indicated the possibility of literal replication (based on similarity) (Yin, 2009, p. 54). In terms of data, Nathans's failure is documented in terms of newspaper articles, magazine articles, and public inquiries.

Secondary Unit of Analysis

The primary units of analysis (for each case) is derived from the research questions and the secondary unit of analysis (for each case) is an embedded unit (Yin, 2009, pp. 29,30,146). The primary unit of analysis, in this research, is the case study organisations (Enron and Nathans). To explore the behavioural aspects of the decision making, a secondary unit of analysis was also selected for both the cases. Kenneth Lay (Enron) and Kenneth Roger Moses (Nathans) are the secondary units of analysis for the purpose of this research. The selection of secondary units of analysis is based on the significance of the position held by the person. Since the selected secondary units played a prominent role in the relevant organisations, they were widely covered in terms of court/judicial inquiries and news, thus ensuring the availability of sufficient data. A text search query in NVivo further confirmed the suitability of Lay and Moses as the secondary units of analysis. It is important to note that this study uses NVivo for the analysis, details of which are provided in the coming sections.

3.2 Data collection

For the purpose of this research secondary data from multiple sources has been used. As discussed earlier, the availability of data has been one of the important considerations in terms of purposeful sampling for this research. Moreover, it was essential to ensure the availability of multiple sources of information to facilitate triangulation of data, which adds to the reliability of the findings (Mellahi, 2005). Archival data from multiple sources were collected for the purpose of this study. Archival data are a rich source of information about the organisations (Patton, 2015, p. 293).The researcher was also able to gain access to the interviews (post failure) of Lay and Moses (secondary units of analysis).

One of the major concerns with secondary data sources such as newspaper and journal articles is the subjective inclusion of information by the writers of that source of data. This may affect the validity of the findings. However, the use of multiple sources of information facilitated the cross checking of data thus adding to the accuracy of data. Further, since secondary data provide *"unobtrusive access when examining sensitive situations, and may reduce distortion due to imperfect recall and social desirability bias"* (Harris, 2001), use of secondary data to explore the behavioural aspects of corporate governance decision making was considered appropriate.

3.3 Data Analysis

The objective of this study was to investigate the role of behavioural aspects in corporate governance failures, by using a qualitative methodology. The primary research questions this study focused on were *"What is the role of corporate governance in corporate failures? Does poor corporate governance lead to corporate failures? If so how?"* The study aimed to analyse and explore the relationship between corporate governance and corporate failures through a behavioural lens. In order to gain insight into the behavioural aspects of corporate governance decisions, this study considered the decision maker as the secondary unit of analysis, along with the primary unit of analysis (the case study organisation).

The study made a critical analysis of existing corporate governance and corporate failure literature. The research followed the best methods and practices in the development of process studies of organisation and management (Ven, 2007; Ven & Poole, 2005) based on the development of case studies of organisational failure (Eisenhardt, 1989b; Eisenhardt, 1991; Eisenhardt & Graebner, 2007; Yin, 1994).

3.3.1 Use of NVivo

The study used a qualitative software NVivo for analysing the data. Initially NVivo 9 was used, but later on the data was transferred to NVivo 10, which eventually was transferred to NVivo 11, as each new version of NVivo provided better features, especially in terms of coding the data from pdf files. NVivo has been recommended for qualitative studies (Bazeley, 2007, pp. 2-3) as it helps in managing the data and keeps records of messy overload of data that is used for a qualitative project. Secondly it helps in managing the ideas. It helps in organising the conceptual and theoretical knowledge, while providing ready access to the context of the data. Thirdly its query feature helps in retrieving all the relevant information that is needed to answer a specific question. Furthermore it also allows graphical modelling and reporting of the data.

This study found NVivo very useful in organisation and quick retrieval of data from a long list of sources which included journal and newspaper articles, court proceedings and judgements, annual reports, and books. The software was immensely useful in analysing data from all the sources, except the books which were not available in electronic form. However, inserts from the books were manually uploaded into the software as and when needed. The use of Query feature of NVivo not only helped in triangulation of data, but also to a large extent helped in avoiding researcher's bias. The thesis provides further details on use of NVivo as and where relevant, in the coming chapters.

3.3.2 The Process of Data Analysis

After uploading the initial set of data into NVivo, the researcher started preparing narratives of the case organisations. Here the basic approach was to follow the advice of Huberman and Miles (2002, p. 57) to read and re-read the data and to look for recurring topics/themes. Once identifiable recurring topics were selected, they were named (coded) in NVivo.

This was the primary stage in the analysis and is termed as first phase of coding. Here, the researcher used an inductive approach (Corbin & Strauss, 2015, pp. 220-237), and did not have a list of codes to start with. Initial data were collected and coded as per the inductive approach. The consideration here was to code the recurring and important aspects related to the case study organisations so as to develop an initial understanding about the organisations. This phase of coding required further data collection as gaps were identified during the coding of data. Further data collection was followed by another phase of of coding, resulting in some new codes and recoding of some of the existing codes. The process of further data collection and revision of codes (coding/recoding) went on until the analysis became saturated, and the researcher had a set of regularly recurring concept codes (Lincoln & Guba, 1990, pp. 343,350).

A set of narrative themes emerged from the first phase of coding. In the context of this study the narrative themes are used to narrate the story of the case study organisation (Chapters 4 and 5) and to present the major aspects (decisions/turning points/milestones) in the life of the selected organisations. Since the narrative themes specifically relate to the individual case study organisations, two distinctive sets of narrative themes emerged for each of the case study organisations. In total there are twelve narrative themes for Enron and a total of seven for Nathans. The results from first phase of coding are used to write the case narratives presented in Chapter 4 and 5. Once the researcher completed the first phase for both the organisations, the research moved into the second stage of analysis.

By now the researcher had the list of the major aspects for each case study, and had also selected the secondary unit of analysis (out of all the decision makers involved in the major events one decision maker was chosen for further analysis) for each case study. The secondary unit of analysis was selected by using the query feature in NVivo. For Enron, Nvivo generated maximum references for Kenneth Lay, who was also the chairman of the company and was part of it from the very beginning. For Nathans the query (using the names of Nathans' Board members) generated highest references for John Hotchin and Roger Moses. However Moses, is considered as the sub unit of analysis for this case as he was the chairman of Nathans; and secondly Hotchin, while associated with Nathans, spent a considerable time outside New Zealand.

The second stage of analysis coded the data on the basis of a 'start list' of codes developed on the basis of the conceptual framework and the research questions. Based on the 'start list' the second stage of analysis started with the coding of the data by using the query feature of NVivo. At this juncture, the conceptual framework and research questions were the best guide in assigning names to the themes (Huberman & Miles, 2002, p. 57)

The second stage was also an iterative stage where the researcher iterated between data collection and data coding. As the analysis progressed, some existing codes were merged and relabelled and some new codes also emerged to sensibly express the regularities and recurrences. This stage involved rereading of existing data along with further data collection in order to fill in the information gaps. During this stage the 'Text search query' in NVivo ensured that no vital information was missed. The query parameters were set to ensure that coding of data was not simply based on the keywords but other (synonyms) words were also duly considered. This increased the chances of finding relevant information from the data and reduced researcher's bias.

The researcher firstly completed the second stage analysis for Enron, and once the second stage of analysis for Enron became saturated, a similar analytical path was adopted for the second case study (Nathans). On the basis of the analysis of both the organisations a set of essential themes emerged. For the purpose of this study the essential set of themes represents the theoretical framework and presents the analysis in the context of the research questions.

3.4 Reliability and Validity

The research consisted of a small sample size of two organisations. The small sample size could be a challenge to the generalisation of results of this study. However, statistical generalisation was not the goal of this research but analytical generalisation (Johnson, 1997; Polit & Beck, 2010; Yin, 2009, p. 43). The objective here was to generalize the case study findings to some broader theory (Yin, 2009, p. 43). Moreover, the information rich cases were purposefully selected to provide useful insights into the selected aspects of corporate governance decision making (Patton, 2015, p. 40).

The research followed the advice of Johnson (1997) to ensure the validity of the findings. According to Johnson (1997), a number of strategies have been used by qualitative researchers to promote the validity of qualitative research. Firstly, this research was an iterative process that allowed a variety of explanations to emerge (during the data collection and analysis phases). By doing so the researcher allowed for rival explanations to emerge, to reach the final findings. This also facilitated cross-checking of information and the conclusions that were drawn from the data. On a further note, use of multiple sources of information ensured data triangulation. The use of multiple sources was valuable in confirming the reliability and trustworthiness of the findings (Johnson, 1997). To ensure the validity of the findings direct quotations from the data are provided. The use of direct quotations provides concrete, detailed and rich descriptions of the phenomenon (under study) to the readers. As a result, the reader can establish a thorough understanding of the concept and draw his own interpretations (Patton, 2015, p. 438).

A potential limitation of the qualitative approach is the researcher's bias. According to Yin (2009, p. 188) the qualitative researcher must avoid selectiveness. This means that the researcher should not only present the evidence that supports his findings and conclusions but present neutrally. As stated earlier, this research has used NVivo for the analysis which ensured that no relevant data were ignored during the coding process (as text search queries have been used). Moreover, detailed results of text search queries (which include the text considered relevant and irrelevant) have been provided as part of the findings (and related Appendices) to make the reader aware of the coding process and its validity. Use of NVivo also helped the researcher to *avoid "selective observation and selective recording of information"* (Johnson, 1997) and has made the coding process more reliable and transparent (Flick, 2009, p. 370).

3.5 Chapter Summary

This chapter provided the details of the research process. The research used qualitative methods to analyse the failure of two case organisations (Enron and Nathans) and thereby, the chapter also provided discussion on the primary and secondary units of analysis. The reasons for using secondary data sources are also provided. The chapter also discussed the data analysis process and the emergence of themes and codes. In this way, the issue of lack of qualitative research, as discussed in Chapter 1, in the field of corporate governance was addressed. The next chapter provides a narrative account of the first case study organisation - Enron.

Chapter 4

Case Narrative - Enron Corporation

According to Pentland (1999) narrative accounts are central to process studies, as they help with understanding the context and explaining the relationships between events. Following the recommendation of DiMaggio (1995) this chapter narrates the important details of Enron's story that are critical to establish an understanding of the context.

4.1 Background

Enron was an American energy company that grew rapidly into other fields. It was once considered the most innovative and successful company in America, winning awards and accolades before going bankrupt in 2001 (Downes & Russ, 2005). Today Enron is known more for its downfall than for its past successes - a fall that wrought havoc (Arnold & Lange, 2004) on the US economy and caused losses of billions of dollars.

Enron was founded in 1985 from the merger of two US based energy companies - Houston Natural Gas (HNG) and InterNorth. Kenneth Lay, who was working for HNG at that time, became the first Chairman and CEO of Enron (Fox, 2003, p. 11; Healy & Palepu, 2003). Lay, who was linked to Enron from before its birth, as well as being the person most referred to in post Enron failure literature, is the sub unit of analysis for this research in the context of Enron. The selection process is already explained in Chapter 3.

Lay, with a doctorate in economics, was from a modest rural family and financed his education through loans, odd jobs and scholarships. Before moving to HNG, Lay worked in senior positions in different organisations including Humble Oil, Florida Gas, the Federal Power Commission, and the U.S. Department of the Interior. Lay was also active on the social front where he raised money for arts and education (Fox, 2003, pp. 7-9). According to Swartz and Watkins, Lay was good at relationship building (Swartz & Watkins, 2003, p. 28) and was well known for his relationships with high profile individuals, including the then President of the US, George W. Bush (Boje, Rosile, Durant, & Luhman, 2004; Swartz, 2001).

4.2 Birth of Enron

As mentioned earlier, Enron was formed from the merger of HNG and InterNorth which was proposed by InterNorth, a company three times larger than HNG (Arbogast, 2013, p. 11; Bryce, 2003, p. 31; McLean & Elkind, 2004, p. 11).The CEO of InterNorth, Samuel Segnar, persuaded the

InterNorth Board to buy HNG, as InterNorth was going through a difficult phase and was facing challenges from deregulation and takeover threats (Arbogast, 2013, p. 11; Collins, 2006, p. 8). InterNorth purchased HNG at a very high price through raising debt. InterNorth believed that this would safeguard the company against takeover, making it unprofitable for others to attempt a takeover (Collins, 2006, p. 8).

Before the narrative is taken further, it is important to consider why InterNorth proposed a merger with HNG. InterNorth was aware that HNG had successfully faced a similar takeover threat (Collins, 2006, pp. 4-5) when the company borrowed a large amount of money and paid $42 million to fend off that takeover attempt. HNG's successful defence against the takeover left it with an unwanted debt and, as its Board was not too happy with this increase in company debt, it recommended a change of CEO for the company. At that time Lay was working for another company named Transco and HNG's Board was very keen to have him as the new CEO of the company, especially as Lay (Transco) had offered to help HNG when it was facing the takeover threat. HNG's Board was impressed by Lay and considered him dynamic and able to face any future takeover attempts (Bryce, 2003, p. 26), so they decided to hire him as the new CEO of the company. Within months of Lay's arrival HNG bought two pipeline companies, extending HNG's pipeline network (Bryce, 2003, p. 31; Collins, 2006, p. 5) and establishing Lay's credibility and reputation for sound business decisions (McLean & Elkind, 2004, p. 9). In a nutshell, InterNorth was considering embracing more debt (to buy another company) so as to reduce its attractiveness for a takeover. HNG had survived a similar situation earlier and Lay had revived HNG's growth (despite the heavy debt), so HNG and Lay were the right choice for InterNorth.

The negotiations for the merger of HNG and InterNorth were headed by Lay (HNG) and Segnar (CEO InterNorth) (McLean & Elkind, 2004, p. 11). InterNorth agreed to pay $70 a share for each share of HNG that was trading at $46 at that time. It was also decided that initially Segnar would be the CEO of the merged company and would be replaced by Lay by the end of 1987. HNG had eight members on the Board of the new company compared to twelve for InterNorth. HNG was also given preference in naming the company as the new company was called HNG InterNorth (Fox, 2003, p. 13; McLean & Elkind, 2004, pp. 11-12). Lay was selling the 'Pride of Houston[1], but he faced no opposition for this. The first apparent reason for the lack of opposition was that the sale was believed to be a merger in Houston and the name of the newly formed company (HNG InterNorth) supported that belief. Secondly, Lay secured a very attractive payout for HNG's shareholders. Despite being the smaller company, HNG also received 40% representation on the newly formed Board. Lay secured a

[1] HNG had been part of Houston (Texas) since 1926. It was a local well-admired company that was the primary gas supplier to the huge Texas based industry. The company was well known in Houston not only for its economic contribution but also for its charitable efforts (McLean & Elkind, 2004, p. 10).

financial gain from this merger as, according to McLean and Elkind (2004, p. 11), he booked a personal gain of $3 million by converting his stockholdings.

Although the merger was completed successfully, it was bound to bring repercussions, especially in the context of the preferences given to HNG in the merger agreement. After the deal, the InterNorth team (Directors of HNG InterNorth who were previously the Directors of InterNorth), realising the extent of the preferences given to HNG, held Segnar responsible for ignoring the interests of InterNorth. The group also feared that Lay would eventually shift the company's headquarters to Houston from Omaha. Since InterNorth was a popular company in Omaha[2] as was HNG in Houston, the shifting of the headquarters to Houston was considered a matter of communal pride by the InterNorth team (McLean & Elkind, 2004, p. 12).

After the merger, this was the first test for Lay who lost no time in hiring McKinsey consultants to investigate the matter and make recommendations on moving the headquarters to Houston. However feelings on the matter were so intense that before the consultants could even give their opinion in favour of Houston, Segnar was made to resign and Lay became the CEO (the 5th highest paid CEO in America (Swartz & Watkins, 2003, p. 29)) of HNG InterNorth on 11 November 1985. An old friend of Lay and another consultant Jeffery Skilling were the McKinsey team working on this issue (McLean & Elkind, 2004, p. 12).

Although Lay was the CEO of the company he still could not win the full support of the InterNorth team. McLean and Elkind mention that at the behest of the InterNorth team, Bill Strauss (a well-respected person in Omaha, who was the Chairman of InterNorth before he gave charge to Segnar in 1981 (McLean & Elkind, 2004, p. 11)) was appointed as the new Chairman of the company. The authors claim that this step was meant to control/restrict Lay's authority at HNG InterNorth (McLean & Elkind, 2004, pp. 12-13). Further, on similar lines, the Wall Street Journal reported Strauss as saying that he was back to support the interests of InterNorth in *"blending these two cultures together"* (Moffett & Richards, 1985). However, Strauss resigned after just four months, giving full charge to Lay. McLean and Elkind emphasised that, even if Strauss had not resigned, Lay would still have maintained a strong hold on HNG InterNorth, as during Strauss's tenure as the chairman, Lay was quietly gaining more support from the directors (McLean & Elkind, 2004, pp. 13-14).

For Lay, it was not only a matter of being the Chairman of the company but also about the (unconditional) support from the Board of Directors. Some of the decisions of Lay indicate that he was focusing on gaining more support from the Board. Mclean and Elkind report that after Strauss's departure, Lay started bringing his friends and supporters on to the Board (2004, p. 13). On the one

[2] InterNorth was the "caretaker of civic causes- the number one corporate citizen" in Omaha (McLean & Elkind, 2004, p. 11). The company had one of the best pipeline networks in America (Bryce, 2003, p. 31).

hand, he was building support for himself and, on the other, he was avoiding conflict with the InterNorth team. Lay's first such decision to avoid conflict was to have dual Headquarter - the Executive Headquarter in Omaha and the Operating Headquarter in Houston (November 1985) (McLean & Elkind, 2004, p. 13; Moffett & Richards, 1985).

Another decision that could have ignited conflict between Lay and the InterNorth team was the appointment of the auditors of the new company. Collins mentions that Deloitte Haskins and Sells were the auditors for HNG, and Arthur Andersen for InterNorth. As per Collins, Lay wanted to avoid conflict and proposed to hire Deloitte as the auditors and Andersen as the primary accounting consultant. However the InterNorth team was not ready for a compromise. Hence Lay, who according to Collins wanted peace with the InterNorth team, agreed to assign both roles to Andersen (Collins, 2006, p. 10). Lay seemed to be so concerned with building support for himself that he gave up a condition in his contract which allowed him severance pay equal to three years' salary and bonuses, if he decided to leave the company within a year (Eichenwald, 2005).

Did Lay really want the board to come together and work as a team? It appears that he was simply buying time to strengthen his position before facing the opposition. By July 1986, Lay had enough support on the Board and decided to shift the company headquarter completely to Houston (McLean & Elkind, 2004, p. 13), stating that Houston is the upcoming *"center for the energy industry"* and that it was strategically beneficial for the company to move the headquarters there (Fox, 2003, p. 15). This decision was resented in Omaha city (McLean & Elkind, 2004) and also by the InterNorth team. It was seen as a signal that Lay was in the controlling seat at Enron ("Enron to Consolidate Its Two Headquarters, Elects Seidl President," 1986). During this time (1986), HNG InterNorth also changed its name to Enron (McLean & Elkind, 2004, p. 13).

4.3 Junk Bond Financing

Lay was not having a smooth journey at Enron, as in 1986 he faced another challenge when the company confronted a major takeover attempt. Takeover threats were quite common at that time and Collins reports that, in the 1980s, Corporate America was facing a situation where a "corporate raider" would firstly attain a significant number of shares of a company's low priced shares and later publicly seek to buy shares to gain control of the company. Even a company like Walt Disney had faced threats from these corporate raiders (Collins, 2006, pp. 2, 7). As mentioned previously, HNG and InterNorth had also faced this situation and now Enron was facing a combined threat from Irwin Jacobs who owned a total of 11.4% of Enron's stock and Leucadia National which owned another 5.1% of the shares of Enron (Fox, 2003, pp. 14-18). According to Collins, to avoid the takeover most of the companies ended up buying back their own shares from these raiders at a very high premium, so Lay was also going to do the same. At that time Enron was already under a huge debt (premium pay out to HNG by Inter North contributed to a large portion of this debt (Swartz & Watkins, 2003, p. 30)) and the energy business was also going through a bad patch (Fox, 2003, pp. 14-18). Moreover the company did not have enough liquid assets (McLean & Elkind, 2004, p. 13). Still Enron decided to buy back its shares at $47 per share against the market price of $44.38 per share, resulting in a total pay-out of $348 million (Fox, 2003, pp. 14-18). Under the leadership of Lay, who did not tolerate rivals (Fusaro & Miller, 2002, p. 4), Enron aggressively faced the threat and used its Employee Retirement Funds ($230 million) and 'Junk Bonds' ($105 million) to buy back its shares (Fox, 2003, pp. 14-18). Junk Bonds were a risky choice as they required Enron to repay the amount within 10 years and at a very high interest rate (Fusaro & Miller, 2002, pp. 4-7).

The 'Junk Bond' aid came from Michael Milken, who converted a low rated investment bank into a prime issuer of risky junk bonds. The bank went down in 1990 amid a scandal with Milken going to jail (Fusaro & Miller, 2002, p. 5). The fall of Milken should have reminded Lay of the 'Do nots', but unfortunately this was not the case, as Fusaro and Miller (2002, p. 8) report that Lay maintained regular contact with Milken, after Milken was caught in the above scam. Lay was seen with Milken at some important events and meetings after Milken's release from jail.

Enron successfully used junk bonds to stop the takeover but the stock market did not respond favourably to this. According to Fox, news about the use of junk bonds by Enron was not well received by stock traders and Enron's stock prices dropped by 9% on the day the arrangement was made public (Fox, 2003, pp. 14-18). But the drop in the stock price was not the real concern for Lay, as what Enron was really struggling with was its mountain of debt acquired from the merger of InterNorth and HNG. According to Fox, junk bonds were just another addition to this pile of debt. Enron vigorously attempted to control its debt-to-capital ratio with various measures, such as freezing the salaries of some of the top executives, selling some real estate investments and the formation of a cost reduction committee. Despite these attempts, Moody's Investment Service downgraded Enron's investment rating to junk status in January 1987 (Arbogast, 2013, p. 5; Fox, 2003, pp. 14-18). Lay, who announced after Strauss's resignation - "*This makes it very clear to everyone that I'm in charge of running the company" (Moffett, 1986),* needed to take accountability for this state of affairs.

4.4 Valhalla Trading Scam

Enron and Lay were trying to control its debt when there came another blow for the company, when one of its leading subsidiaries - Enron Oil, Valhalla - an oil trading division of Enron (Fusaro & Miller, 2002, p. 21), became involved in a trading scam in 1987 (Fox, 2003, pp. 18-21). On 23 January 1987, Enron's internal auditors received a call from a bank in New York, stating that a bank account in the name of Enron had been opened, and that the bank had noticed some suspicious transactions in that account. Further investigations revealed that two traders (Louis Borget and Tom Mastroeni) at Enron Oil had been using fictitious transactions since 1985 to shift profit from one quarter to another, and this particular bank transaction was part of the practice. John Harding and Steve Sulentic, Enron's senior employees based in Houston, were formally responsible for overseeing the operations of Enron Oil; however, they were only nominally involved in the work at Valhalla, especially when they were based outside Valhalla (McLean & Elkind, 2004, pp. 17-19). This meant that the trading unit was not subject to regular monitoring.

Borget and Mastroeni were called to Houston on 2nd February 1987 to investigate the problem. The meeting was held in the office of Mick Seidl, a very close aide of Lay, and Enron's internal auditors, Harding, Sulentic and many other senior executives of Enron, including Richard Kinder and other close confidantes of Lay, were present at the meeting. Borget and Mastroeni stated that they were merely shifting the profits from one period to another as earnings in excess of a certain value in a period were not expected to do much good for Enron. Borget explained that profits were shifted from one period to another to ensure that Enron's performance appears to be steadily progressing towards its projections. He said that excessive profits in one year followed by not so good profits next year would have sent negative signals to the market (Eichenwald, 2005). Borget also said that Enron's senior management had advised them to shift the profits. His division, Enron Oil did have a sudden jump in its profits, it earned a profit of $10 million in 1985 and $28 million in 1986. Enron wanted to shift profits not only to save on tax, but also to sail through the rough patch. At that time the gas industry was facing the impact of changes in regulations, making the time difficult for Enron which was already under huge debt and was also facing a serious cash crunch. The company also needed to show a certain level of income every quarter to get loans from banks and other institutions (McLean & Elkind, 2004, pp. 17-18).

Sulentic justified their actions saying that they were *'sincerely'* working for the benefit of Enron by shifting profitability from one period to another. Towards the end of the meeting everyone appeared satisfied that even though the method used by Borget and Mastroeni was *"not acceptable"* they were sincerely trying to achieve some benefit for Enron, hence no punishment should be imposed (McLean & Elkind, 2004, p. 19). The meeting concluded with Lay saying *"I just don't want this to happen again……… (next time) the profits have got to be reported properly"* (Eichenwald, 2005).

Enron's internal auditors continued with further investigation, which later was handed over to Arthur Andersen who had certain concerns and wanted to talk to the two traders about that. Seidl informed the two traders in advance about the concerns that Andersen had (McLean & Elkind, 2004, pp. 19-20) and, in a message to the traders, after the meeting with Andersen, Seidl thanked them for their *'perservance'*. He said that they gave very good answers to Andersen and that he had complete faith in them. He concluded "*please keep making us millions…*" (McLean & Elkind, 2004, p. 20).

Andersen presented their report to the Board in late April 1987, stating that they were unable to trace or verify some of the trading partners, and that the particular bank account transaction under investigation was intended to shift profits only. They also made the Board aware of the lack of proper control at the division and that the traders were not keeping proper records. They left it to the Board to decide if the transactions were material enough to require disclosure in financial statements. The Board decided that the transactions were not of much significance and need not be disclosed in financial statements. The traders were also not fired but were put under control and supervision (McLean & Elkind, 2004, p. 20). Details in Swartz and Watkins indicate that it was primarily Lay's decision not to fire the traders, but to enforce more control, whereas Kinder preferred to fire them all and close the unit (Swartz & Watkins, 2003, p. 32).

Lay had warned Borget and Mastroeni, and given them another chance but the traders did not pay attention to him and often exceeded the trading limits (often 10-20 times over the limit (Fusaro & Miller, 2002, p. 18)) set by the company (Swartz & Watkins, 2003, p. 32). This was a symbolic management gesture used by Enron that was ceremonial in nature. Mike Muckleroy, the head of Enron's liquid-fuels division and an experienced commodity trader, became suspicious of the dealings at Valhalla, and took his concerns to Seidl. He told Seidl that he feared that the traders at Valhalla were exceeding the limits set by the company, which was dangerous. But Seidl rejected Muckleroy's claim, stating that he was jealous of Borget because of the bonus ($10 million in 1985 and $9.4 million in 1986 (McLean & Elkind, 2004, p. 17)) Borget and his team has received. Despite that, Muckleroy kept taking his concerns to Seidl time and again, and finally Seidl sent him to Lay who told him that he was making a big issue out of nothing. Muckleroy asked Lay *"What do I have to do to get you to understand that this could do devastating damage to our company".* But Lay was not ready to listen and despite the concerns raised by Muckleroy, Enron's Board increased the trading limits of Borget by 50%, that too within a few months of Lay's meeting with Muckleroy (McLean & Elkind, 2004, pp. 20-21). Lay paid ceremonial attention to the issue that was merely a symbolic gesture to manage or control the issue.

Meanwhile, Borget kept on with the unauthorised trading and was maintaining two sets of books and reporting inflated results to Enron headquarters. When the situation became too out of control for Borget to manage, he himself informed Seidl of the situation. At that time, owing to unauthorised trading, Enron Oil was short on 84 million barrels which meant that the trading division had sold more oil than it actually had. All this was about to cost $1 billion plus to debt ridden Enron (which already had a $4 billion debt at that time (McLean & Elkind, 2004, p. 22)). Lay immediately fired Borget and Mastroeni and appointed Muckleroy to find a solution (McLean & Elkind, 2004, pp. 22-24). Muckleroy handled the situation, but still it cost Enron around $140 million (Fox, 2003, p. 18; McLean & Elkind, 2004, p. 22). According to McLean and Elkind, Lay and his team pretended ignorance of and shock about the whole incident. The whole affair was termed *"the cost of success"* by Lay (Fusaro & Miller, 2002, p. 22).

The Valhalla scandal brought Kinder to the forefront replacing Seidl (Eichenwald, 2005). According to Eichenwald (2005), Seidl continued to work at Enron but most of his authority shifted to Kinder, who was known to Lay from college days and became the 'Chief of Staff' in August 1987. He was tough, demanding, decisive, and was described as having natural authority (McLean & Elkind, 2004, pp. 24-26).

4.5 Gas Bank and the Arrival of Jeffery Skilling

In the beginning Enron mainly focused on supplying natural gas through its vast network of pipelines. At that time the natural gas industry was regulated and was very stable, but the industry was deregulated in the mid-1980s (Healy & Palepu, 2003). Deregulation changed the way the industry operated, and the industry faced unstable and unpredictable prices and supply (Swartz & Watkins, 2003, p. 44). Prior to deregulation, gas distribution (pipeline) companies had no choice but to opt for "take or pay contracts". Take or pay contract were signed by pipeline companies with gas producers, where they guaranteed to buy a minimum amount of gas from the producers. Failure to do so required a penalty to be paid by the pipeline company to the gas producer. Since the pipeline companies were almost certain of the supply, it created a "reliable demand"(Fox, 2003, pp. 10-11). Initially, after the deregulation, pipeline companies were happy to cancel their "take or pay contracts" and choose the "spot market". As soon as the new form of market became fully functional, related problems became apparent. In the free-regime gas prices rose significantly and the supply became unreliable. In the absence of take or pay contracts, pipeline companies were unable to ensure an uninterrupted supply of gas and Enron was no exception in all this. Lay, who was a strong supporter of deregulation, felt that Enron needed to find a new way to do business to grow and survive (Swartz & Watkins, 2003, p. 44).

Lay's search for a growth opportunity for Enron took him to Jeffery Skilling and McKinsey & Co., a consultancy firm. At that time Skilling, who would later play an important role at Enron, was a consultant at McKinsey. Skilling suggested an idea to harvest the benefits from deregulation by proposing a Gas Bank (McLean & Elkind, 2004, pp. 27-29).The Gas Bank, a new form of market, proposed by Skilling focused on networking gas suppliers and consumers. Skilling proposed that

Enron work as a bank that would intermediate between suppliers and buyers of natural gas, and would contractually guarantee the supply of gas and its price. In return Enron would charge fees for the transactions and for the associated risks (Thomas, 2002).

McLean and Elkind noted that this new idea was based on the gap between the needs of customers and the suppliers of gas. It mainly focused on the way the market "should" operate rather than looking into the "would" scenario (McLean & Elkind, 2004, pp. 27-29).

Lay liked Skilling's idea and Enron gave the green light to the formation of the Gas Bank, negotiating long term contracts with natural gas suppliers and then slicing and dicing them to match consumers' needs. The Gas Bank offered consumers an option to buy gas at a later stage but at a predetermined price. The consumers also had an option to 'swap' these fixed price contracts for a floating price, with Enron (Fusaro & Miller, 2002, pp. 29-34).

Since the Gas Bank was dealing in long term contracts with gas producers, Enron felt the need to manage the risk associated with price changes. It wanted to do 'financial trading' in gas supply (gas trading) so as to complement and support its physical supply of gas (gas selling). Enron started a trading division in partnership with a well-known derivative expert, Bankers Trust. The aim of this division was to facilitate the hedging of gas prices by gas producers and gas consumers. Gas trading became a success and by 1990 it constituted 75% of all gas sales (Fox, 2003, pp. 22-35).

The Gas Bank transformed Enron. It was less like a pipeline company that focused on physical assets, it actually was being transformed into a trading company that focused on financial derivatives and other financial instruments (Fox, 2003, p. 37). Now Lay needed someone to assist him in the whole process. Lay was so impressed with Skilling's work that in June 1990, almost a year after Skilling's McKinsey assignment, Enron opened its door to welcome Skilling as the CEO of Enron Gas Services[3] (Fox, 2003; Fusaro & Miller, 2002, p. 33; Healy & Palepu, 2003). Soon after his arrival at Enron, Skilling hired a close lieutenant of his, Andrew Fastow (Fusaro & Miller, 2002) who, like Skilling, would play a significant role in Enron's future.

4.6 MM Model

Enron's trading business was growing rapidly. A company with a strong belief in physical assets was moving into intangible assets as now at Enron mostly *"only money, not gas changed hands.* Enron's trading division was growing very fast. It had only 144 employees in 1990, rising to 548 in 1992. In

[3] Enron Gas Services was later named as Enron Capital and Trade Resources.

1990, Enron's Gas Bank and trading operation earned 3.7% of Enron's total earnings before interest and taxes, and in 1992 these earnings grew to form 12.4% of the total (Fox, 2003, pp. 27, 39).

In the midst of these developments Enron was facing a complex problem: how to value the long-term contracts for natural gas for the purpose of recording in Enron's books. It was a unique and complex situation for Enron, for which there were no clear answers available at that time. Since the Gas Bank and trading were a new concept of its own kind, there was no historic price to refer to (Fusaro & Miller, 2002, p. 35). But Enron had to find a way out and it decided to use a mark-to-market model (MM Model), from January 1991 (Fox, 2003, p. 40), and it became the first ever non-financial company to use mark to market accounting (Mack, 1993). Mark-to-market is a standard practice at financial institutions to value their investment in stocks. The shares are recorded at current market prices and the resulting difference between the historic price and the market price is a gain or loss. Thus the mark to market method can add to the profits/losses of the company without the sale of anything (Fusaro & Miller, 2002, pp. 34-35).

Adoption of the MM Model changed Enron's culture to aggressive, risk-taking and 'profit-first'. It can book profits, on a particular day, due to an upward movement in prices and is capable of hitting back badly the next day with a downfall in prices (Fusaro & Miller, 2002, pp. 34-36). Under the MM Model financial institutions need not sell their financial/stock holdings to book a profit - Enron would also follow the same path in future (booking profits on the basis of the valuation of its long term contracts to supply gas). Further implications of the MM Model for Enron will be discussed in later sections of the chapter. At this point, it is enough to understand that the adoption of the MM Model on the one hand made Enron prone to price fluctuations and, on the other hand, it had an immediate positive effect (Batson, 2003b) on Enron's reported earnings. On the basis of information drawn from Gillan and Martin (2007), the following table (Table 4.1) provides a comparison of Enron's profit margins, before and after the introduction of the MM Model. The table clearly indicates that Enron's net profit margin increased with the adoption of the MM Model.

Table 4.1 (Impact of the MM Model on Enron's profit margins)

Before the Mark-to-Market Model		After the Mark-to-Market Model	
Year ended	Net profit margin	Year ended	Net profit margin
Dec-85	1.2%	Dec-91	4.3%
Dec-86	-1.4%	Dec-92	5.3%
Dec-87	0.9%	Dec-93	4.2%
Dec-88	2.3%	Dec-94	5.0%
Dec-89	2.3%	Dec-95	5.7%
Dec-90	1.5%	Dec-96	4.4%

Enron was reaping the benefits of the MM Model, but it was to face trouble in the future. As Fox explains, the use of the MM Model was not as easy for Enron as it was for other financial institutions. It was very difficult for Enron to calculate the market value of its long term contracts, which spread to 4-5 years or even more. There was no available basis for calculating the discounted present value of these contracts. Even the New York Mercantile Exchange (NYMEX)[4] had gas futures contracts spread to a maximum of only 18 months. Hence in the absence of any benchmark, Enron's traders were responsible/free to value their trades on the basis of their own assumptions and judgements (Fox, 2003, p. 41).

In the coming years, some serious issues would arise for Enron from its adoption of the MM Model. However Enron was reluctant to admit to the drawbacks of using the MM Model and it was unwilling to pay attention to the criticism of the suitability of this model for Enron. It attended to the feedback/information coming from close/trusted sources only. In May 1993, Forbes magazine criticised and warned Enron of the shortcomings of the MM Model. It said *"Ken Lay's Enron Corp. has been a smashing success [but]…here are some things that could go wrong……. HIDDEN RISKS"*. It warned Enron that the uncertainty and risk associated with the long-term contracts offered by Enron were so high that a $49 million reserve set aside by Enron for the unexpected loses, might not be adequate. It also cautioned that booking profits on the basis of the MM Model would require Enron

[4] NYMEX introduced gas futures contracts in 1990 (Fox, 2003, p. 28).

to search constantly for growth and to enter into more and more long term contracts (to keep the profit cycle going) (Mack, 1993).

The objections raised by Mack (1993) should have alarmed Enron, but instead of assessing the risk, Enron went on defending its decision to adopt the MM Model. Not only Lay, who wrote to Forbes and Mack to express his anger, but also some of the Wall Street security traders and analysts defended Enron. Donaldson, Lufkin & Jenrette Securities Corp. supported Enron saying *"We regard the 'Forbes' recitation of risks as an inaccurate portrayal of the business and as showing a lack of understanding of the operations of the EGS [Enron Gas Services] and the industry".* Lehman Brothers termed the Forbes' story *"misleading..... [that] demonstrates a considerable lack of understanding"* and supported Enron that it *"is an even better company than investors believe" (Swartz & Watkins, 2003, pp. 48-49).*

Enron, a large company, which contributed 20% of the total sale and transport of natural gas in the US in 1993, and whose stock at that time was trading at three times higher than its book value (Swartz & Watkins, 2003, p. 48), failed to consider the sensitivity of the issues raised by Mack (1993). The external support that Enron had for its MM Model appeared to be fictitious since the Wall Street analysts supporting Enron did have business interests linked to Enron.

In 1990, Enron Gas Trust offered 10 million units to the public, valued at $5.35 a unit. These were underwritten by three security trading firms including Donaldson, Lufkin & Jenrette and Lehman Brothers ("Financing Business: Enron Corp," 1990; "Recent SEC Filings," 1990). Two security analysts, Laurence Nath and Dominic Capolongo (who worked for Donaldson, Lufkin & Jenrette), played a significant role in Enron's international projects in the later years (Charles & Randall, 2002).

4.7 Special Purpose Entities (SPEs)

4.7.1 Origin of SPEs

After Enron's failure, its relations with the Wall Street firms were questioned by many, including the Securities and Exchange Commission, the Justice Department, and the House Energy and Commerce Committee (Charles & Randall, 2002). Even though *"Wall Street firms wore a number of conflicting hats for Enron, serving as an underwriter on Enron stock and bond deals, and often providing positive research on the company's stock"* (Charles & Randall, 2002), it was the role they played in the SPEs that raised major concerns. Many Wall Street executives invested millions of dollars in Enron's SPEs. For example about 100 analysts from Merrill Lynch invested nearly $16 million in one of the SPEs (LJM2) (Charles & Randall, 2002).

After the Gas Bank and the MM Model, SPEs were the next big change at Enron. The origin of SPEs goes back to the Gas Bank as, for the success of the Gas Bank, Enron not only needed customers who were ready to sign long term contracts to buy gas, but also gas suppliers/producers who were ready to sign long term contracts to supply gas to Enron at a fixed price (Fox, 2003, p. 35). According to Fox, most of the gas producers were reluctant to lock in a long-term fixed price with Enron, as they believed that the gas prices were going to rise in future.

In this case Enron had no choice but to rely only on those gas producers who had urgent cash needs. However, owing to its debt burden, Enron itself was not in a comfortable position as far as cash was concerned and found an innovative solution for this problem in the form of Special Purpose Entities (SPEs) (Fusaro & Miller, 2002, p. 36). In simple terms, an SPE is a kind of trust formed by a company to carry some of its assets. The SPEs helped organisations in many ways as a legitimate option to wipe a risky account from the company's books, provided certain conditions are met or to arrange cheap finances for the company (Fox, 2003, p. 63).

According to Fox (2003, p. 63) Enron started using SPEs in 1991 by adopting a Volumetric Production Payments (VPP) strategy. The VPP strategy aimed to provide loans through an SPE to the gas producers which were to be paid back later in the form of an oil and gas supply (Cornford, 2004; Fox, 2003, p. 63). The problem here was the time lag between the cash payment and the actual delivery of the oil and gas. According to Fox, VPP was not working for Enron as it could not recover its money until it received the supply of oil and gas to sell. To arrange money for VPP, Enron started to rely on SPEs (Fox, 2003, p. 63).

Initially, as mentioned above, the SPEs were only used to nurture the energy trading projects of Enron; however, later on they were used for numerous justifiable and unjustifiable reasons. It was at this time Enron started the ceremonial adoption of the regulations related to the SPEs. The main SPEs used by Enron include JEDI, Chewco, Raptors, LJM, and Rhythms. A 'Word Frequency' query in NVivo was used to find out the main SPEs used by Enron. The word frequency query was set for a minimum of 3 letters a word to search for 1000 most frequent words under the node 'SPE'. The results showed a range of words within a range of 3-18 letters a word. The frequency counts for these words ranged from 3-652. JEDI, Chewco, Raptors, LJM, and Rhythms were the only names of Enron's SPEs shown in this query's results, and, hence are considered relevant SPEs to look into, as part of this research.
The following section details JEDI and the rest of the SPEs are discussed in later sections.

4.7.2 JEDI (Joint Energy Development Investments)

In 1993, Enron entered into a joint venture with California Public Employees' Retirement System (CPERS) for the formation of a new SPE named JEDI (Fusaro & Miller, 2002, p. 61). Enron contributed $250 million in the form of Enron stock and CPERS contributed $250 million in cash at the time of formation of JEDI (Powers, Troubh, & Winokur, 2002, p. 43). According to Fusaro and Miller, this SPE not only helped Enron with its liquidity crunch, without adding any liabilities to its balance sheet, but also added to its credibility as well, as CPERS was the largest public pension fund in the US at that time (2002, p. 67). JEDI financed many big deals for Enron including $62 million to Forest Oil and $60 million to Flores & Rucks (Fox, 2003, p. 65). Up to this point the use of SPEs at Enron was legitimate; however, later on Enron started using SPEs in ways not approved by law and these will be discussed later in this case study.

4.8 Young Gun Strategy

Enron was evolving and spreading into unregulated and competitive markets. As discovered by Fox (2003, pp. 78-82) Enron was venturing into new areas and needed able lieutenants to take risks and pursue new options. Fox states that Enron developed a recruitment strategy, referred to as the "Young- Gun-Strategy" (YGS) in this study, to recruit fresh graduates, who had a sense of urgency, passion and enthusiasm for work (in view of the long working hours) (Fusaro & Miller, 2002, pp. 48-51).

This was the time when Enron's culture and basics were going through a major change. Lay, who earlier believed in acquiring physical assets to strengthen a company, was coming round to the view that *"the energy business is becoming more and more of a knowledge industry ….. Enron is going to become more of an information industry and less of a hard asset-driven industry."* According to him leaders from *"…financial and marketing backgrounds, compared to the engineering backgrounds…."* were the future of the energy industry (Lay, 1996, pp. 357, 363).

From the very early days of their arrival at Enron, the new recruits faced fast paced and cut-throat internal competition. Enron always over-recruited, which meant that there were large numbers of new arrivals who fought for limited opportunities. It was a matter of survival of the fittest at Enron and to survive one had to outperform his/her colleagues. Fox also notes that the over-recruitment tactic at Enron created a big talent reserve for the company and it was very easy for it to get rid of the lowest performers and replace them with the higher performers (2003, pp. 78-82).

In the early 1990s, along with YGS, Enron adopted a harsh new performance review system which was introduced by Skilling and Fastow and aimed at getting rid of the lowest 20% performers each year (Boje et al., 2004). The new system would have a big impact on Enron and its culture, and is discussed in the following section.

4.8.1 Performance Review System (PRS)

The PRS, on one hand was a job loss threat for some employees (Boje et al., 2004), but, on the other hand it generously rewarded the high performing individuals ("The Environment was ripe for abuse," 2002). The performance review committee consisted of Enron's managers, who met twice a year to review the performance of its employees (Fox, 2003). The PRS linked the individual rewards to individual rankings with the top 5% being the 'superior' group, who got 66% higher bonuses than the next 30%, the 'excellent' group ("The Environment was ripe for abuse," 2002). This review was of great importance for individual employees, as the bonuses formed a major part of their individual earnings from Enron (Fox, 2003, pp. 83-87).

Feedback from managers was a vital part of the PRS (Fox, 2003, pp. 83-87) and managers enjoyed greater control over their subordinates. The PRS compared performance of one employee with others (Fox, 2003, pp. 83-87) leading to an internal competition at Enron. Moreover the employees knew that they had to beat their colleagues, not only to avoid being placed in the lowest 20% but also to earn high bonuses.

The following narrative of one of the Enron employees recorded by Fox (2003, p. 86) shows the intensity of the competition faced by Enron employees:

> *"…….you had to run very fast to keep up."*

Enron's senior management was also aware of these silent changes in the culture of Enron and the following statements by Skilling (Fox, 2003, pp. 86, 171) confirm their awareness and affirmation:

> *"Our culture is a tough culture. It is a very aggressive, very urgent organisation."*
>
> *" You need to add intellectual value-added to make a buck anymore………………you have to weed out the dead weight."*
>
> *"The difference between someone that's good and someone that's mediocre is not a factor of 50 percent -it's a factor of 200 or 300 times."*
>
> *"If your managers aren't waking up at 3 a.m. sweating, you are doing something wrong."*

Enron was gradually transforming itself into a company devoted to booking profits only (Fusaro & Miller, 2002, p. 47). Even though the system was introduced by Skilling and Fastow, Lay also seemed to support the new system: *"Individuals are empowered to do what they think is best ...... We do, however, keep a keen eye on how prudent they are ...… We insist on results"* (Fusaro & Miller, 2002, p. 47). Enron was empowering its employees to deliver results, and the PRS was making them do anything to survive.

Lay was also proud of Enron's compensation system, which was obviously linked to the PRS. He was fully satisfied with the system and acknowledged *"An important part of our [Enron's] corporate culture is individualised compensation"* which, according to him, was based on the performance of the individuals. He recommended that the oil companies should *"deviate from their hierarchical, one-size-fits-all compensation system"* and adopt a compensation system similar to that of Enron. According to Lay, employees are happy to work away from their homes and for long hours, when they know that equally great compensation is waiting for them (Lay, 1996, pp. 357-358).

4.9 Intellectual Capital and Asset Light Diversification

The adoption of strategies such as the YGS and the PRS was linked to Enron's inclination towards "intellectual capital". Skilling was a great supporter of "intellectual capital" and believed that money can be minted by using it and, for Enron, the ideas were the creation of a new form of market (Fusaro & Miller, 2002, pp. 56-57). Skilling was going to transform his ideas into reality with an "asset-light strategy" and widespread diversification. His idea of asset-light was a good fit with Lay's belief (Fusaro & Miller, 2002, pp. 44,53) in the creation of new markets.

Skilling had to wait for the departure of Kinder in 1997 to fully implement his plans at Enron. Kinder, a close associate of Lay and the Chief Operating Officer of Enron, was in favour of acquiring physical assets capable of generating tangible profits (Fusaro & Miller, 2002, p. 57; Stein, 2007). Kinder's idea of physical capital was the total opposite of Skilling's idea of intellectual capital.

Kinder used to critically analyse a project proposal before agreeing to it. He believed that, to be picked up, any major investment had to be economically sound (Fusaro & Miller, 2002, p. 57). According to Fox, Kinder preferred to invest in tangible assets instead of intangible assets. His priority was pipelines and power plants and his belief in investment in hard assets was so strong that even after leaving in 1997, he formed a company and bought a pipeline company from Enron (Fox, 2003, pp. 98-99). Kinder's departure reduced the resistance that Skilling could have faced in putting his asset light plans in place.

Another change was happening in Enron, in terms of Lay's involvement in Enron's affairs. Lay worked extremely hard for the success of Enron in its initial years, but now he was more into developing his public image (McLean & Elkind, 2004, pp. 85-99). In a way Lay was the face of Enron in the outside world and Kinder was the driving force inside Enron (McLean & Elkind, 2004, p. 86). After Kinder's departure Skilling took his place and became the CEO of the company (Fusaro & Miller, 2002, p. 39). According to Fusaro and Miller, with Skilling replacing Kinder, Fastow, who was a close associate of Skilling, also became influential in Enron and was appointed as the Chief Financial Officer of Enron in 1998. Skilling had a firm belief in asset light, as he stated: *"It's very hard to earn a compensatory rate of return on a traditional asset investment… In today's world, you have to bring intellectual content to the product, or you will not earn a fair rate of return"* (Deakin & Konzelmann, 2003).

Hence after Kinder's departure, Enron started combining "financial contracts" with "physical delivery contracts" for different types of markets, including metals, pulp and paper, water, electricity, and broadband (Fink, 2002; Gillan & Martin, 2007). Enron was being transformed into an asset light organisation, and according to Fink, before its downfall in 2001, 90% of Enron's revenue came from intangible trading business. The increased reliance on trading activities required Enron to closely watch its credit rating. Enron confirmed this in its annual statement: *"Enron's continued investment grade status is critical to the success of its wholesale businesses as well as its ability to maintain adequate liquidity" (Enron, 1998, p. 41). According to* Fastow, Enron's trading business depended *on "the counterparties who enter into these [trading] contracts with Enron …… [and are ready to take]…. Enron counterparty risk"* (Fink, 2002). It meant that Enron had to rely on a high credit rating or its ability to honour its trading contracts would be doubted, which would ultimately affect its trading business (Gillan & Martin, 2007).

In addition Enron required liquidity for its asset-light business, as the company needed sufficient liquidity to fulfil its commitments as a counterparty in its trading contracts (Culp & Hanke, 2003). Enron itself acknowledged in one of its Annual Report that *"… unrivalled access to markets and liquidity"* is the primary requirement for Enron to meet its commitments (Enron, 2000, p. 6).

Since the adoption of the MM Model, Enron was reporting income on the basis of value appreciation of its long-term trading contracts. As stated previously, Enron was heavily reliant on its trading business which meant that, despite the rise in its net income (Gillan & Martin, 2007), not much cash was coming in (Batson, 2003b, p. 87). According to Batson, Enron could not afford to have more debt as it would have affected its credit rating. Secondly Enron was already carrying huge debt. Since its formation in 1985 until its end in 2001, Enron's debt ratio never came below 70% (Gillan & Martin, 2007).

Hence Enron needed a solution that did not have a negative effect on its credit ratings, but improved its liquidity, and did not lead to a rise in its already soaring debt ratio. Skilling and Fastow believed that SPEs were the perfect solution. Hence they initiated the process of forming more SPEs, which would not only bring income or finances for Enron but would also keep related charges off Enron's balance sheet (Batson, 2003b, pp. 8-9; Fink, 2002; Fusaro & Miller, 2002, pp. 36-37).

Unlike JEDI, in future, Enron did not form another SPE in alliance with a public company. Fastow wanted a flexible solution in which, he said, *"You can get together with one or two investors and craft a particular structure to meet your and their objectives, which is very difficult if you have a public entity [where] you might have to go with shareholders' votes and amendments of charters and the like"* (Fink, 2002). In the future Enron would form more SPEs (Chewco, Raptors, LJM and Rhythms) in partnership with private investors.

4.10 Chewco

In November 1997, the Executive Committee of the Board of Directors of Enron gave approval for the formation of another SPE called Chewco (*Minutes of Meeting of the Executive Committee of the Board of Directors Enron Corporation held on 05 November*, 1997). The formation of Chewco was linked to JEDI - the other SPE used by Enron in 1993. Enron was pleased with the results it was receiving from JEDI as it recorded a profit of $68 million from JEDI in the year 1997. It intended to do another joint venture (JEDI2) with CPERS on the pattern of JEDI, but Enron was aware of the problem that CPERS would not invest in JEDI2 at the same time as it had investments in JEDI (Fox, 2003, p. 122; Powers et al., 2002, p. 43). Hence Enron needed a third party to replace CPERS' share in JEDI, so that CPERS was free to invest in JEDI2.

JEDI was jointly controlled by Enron and CPERS and it was not consolidated into Enron's accounts as Enron wanted to maintain JEDI as an unconsolidated entity (Powers et al., 2002, p. 43), to avoid JEDI's debt to add to its balance sheet (Fox, 2003, pp. 122-123), and also needed a third party to buy CPERS's share in JEDI. As a result, Fastow, the Senior Vice President of Finance, proposed the formation of Chewco (Fox, 2003, p. 123) as he believed that Enron's off balance sheet activities through SPEs provided it with *"a structural cost advantage" (Fink, 2002)*. Enron was in a hurry to sort out the formation of the new SPE, Chewco, so that it could carry out some transactions with it before the year end (Fox, 2003, p. 122). The situation was that Enron needed a third party to buy CPERS's share in JEDI and in a short period of time.

In the beginning Fastow proposed himself as the manager of Chewco on behalf of the third party, but his inclusion therein would have required disclosure in a proxy statement, because of the kind of position he held at Enron, along with approval from the Chairman and CEO of Enron (Batson, 2003a,

p. 98; Powers et al., 2002, p. 43). Enron's legal counsel, Vinson & Elkins, advised Fastow against his inclusion in Chewco, so Fastow replaced himself with Michael Kopper, his close aide from Enron. Kopper's position at Enron was not one that required a disclosure in Enron's proxy statements, upon his involvement in Chewco (Powers et al., 2002, p. 43).

As stated earlier, Enron was in a hurry to finalise the setting up of Chewco, and Enron's legal counsel prepared all the documents within two days of the finalisation of Kopper's name and redemption terms with CPERS. Finally in November 1997, Chewco was formed, and also an agreement was reached with CPERS for a redemption price of $383 million. Chewco arranged the money mainly by borrowing from banks, guaranteed by Enron (Powers et al., 2002, pp. 44-45). The complex capital arrangement, reported in the Powers Report, of Chewco is shown in the following diagram (Figure 4.1):

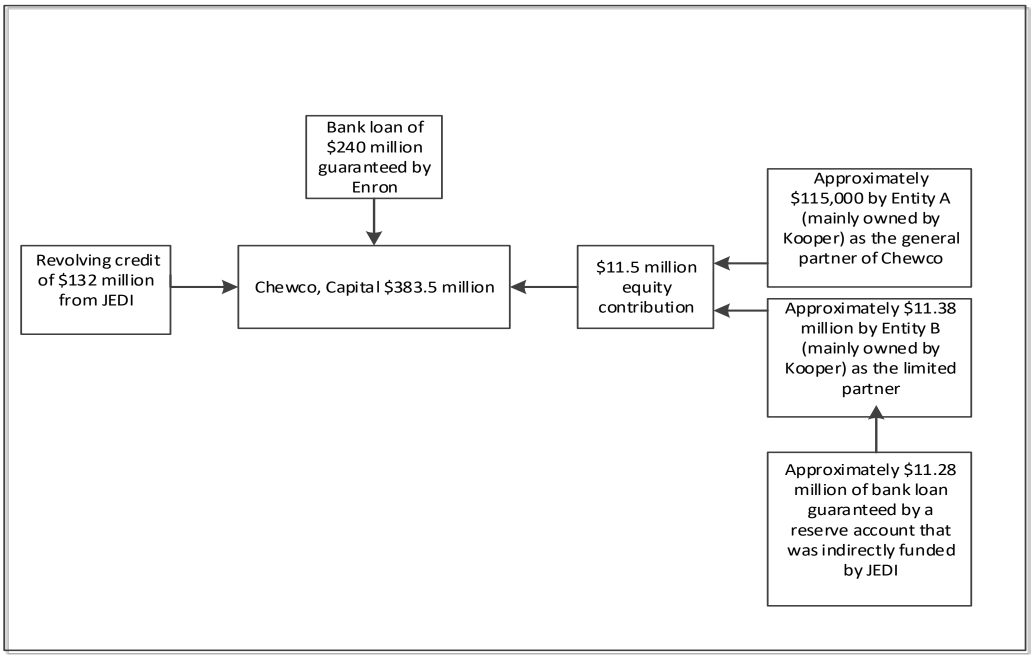

Figure 4.1 (Capital Structure of Chewco)

Chewco was presented for approval in a meeting of the Executive Committee of Enron's Board, on 5 November 1997, which was attended by all the Committee members[5] via a telephonic conference. The minutes of the meeting reflect that Chewco was given the green light without any opposition from any of the committee members (*Minutes of Meeting of the Executive Committee of the Board of Directors Enron Corporation held on 05 November*, 1997). The minutes of this meeting were also presented to a full Board meeting on December 9, 1997 and no inquiries were made by the Board

[5] The committee members included: John H. Duncan (Chairman), Robert A. Belfer, Joe H. Foy, Kenneth Lay, Charles A. LeMaistre, Jeffery K. Skilling, and Herbert S. Winokur Jr.

then either (*Minutes of Meeting of the Board of Directors of Enron Corporation held on 09 December*, 1997).

As referred earlier, Enron did not need to disclose Kopper's involvement in Chewco to the outside world, but its own code of conduct did require Kopper's participation to be approved by the Chairman and CEO of Enron. However, Lay admitted, during post Enron investigations[6], that he did not know Kopper and had never approved his participation in Chewco (Powers et al., 2002, pp. 46-47). Lay's claims accord with Skilling's statement to the Powers committee (Powers et al., 2002, p. 47) that he approved Kopper's participation on the recommendation of Fastow. Moreover this issue appears not to have been discussed during the Executive Committee meeting either (*Minutes of Meeting of the Board of Directors of Enron Corporation held on 09 December*, 1997). The formation and approval of Chewco demonstrates how Enron had ceremonial adoption of regulations as a gesture of compliance.

Enron intended to soon replace the bridging finance structure with some other structure, which was another indication of the urgency on the part of Enron to form Chewco. However, the formation of Chewco fully served the purpose for Enron and helped it to inflate its earnings (Powers et al., 2002, pp. 45, 56-59). Later, in March 2001, Enron bought Chewco back, following a proposal by Fastow. The buyback awarded great returns to Kopper and William Dodson (since Kopper transferred some of his share in Chewco to Dodson (Fox, 2003, pp. 124-125)). In total they received $10.5 million from their $125,000 investment in Chewco (Fox, 2003, p. 232). The statement by Jeffrey McMohan (the Senior Vice President, Finance and Treasurer of Enron) to the Powers committee and some other evidence collected by the committee indicates that Fastow played a crucial role in securing a higher pay-out for Kopper and Dodson (Powers et al., 2002, p. 61). At the time Skilling's hold on Enron was increasing as he became the CEO of Enron in February 2001 (Thomas, 2002).

4.11 LJM Partnerships

LJM partnerships included the formation of two significant SPEs by Enron, namely LJM1 and LJM2. The following section provides details of their formation.

4.11.1 LJM 1

LJM partnerships were the other significant SPEs formed by Enron. The roots of these go back to Enron's investment in Rhythms Net Connections, a private company which provided high speed internet, in March 1998 (Fox, 2003, pp. 148-149). According to information from Fox, in March 1998

[6] All the investigations after the fall of Enron, either by Enron itself or by any other body, into the collapse of Enron or issues related to collapse of Enron, are termed post Enron investigations for convenience.

Enron invested in 5.4 million shares of Rhythms at a price of $1.85 per share. Rhythms offered its share to the public in April 1999, at a price of $21 per share. After the public offering, Rhythms' share price started rising, and by May 1999, Enron's $10 million investment in Rhythms was worth $300 million (Fox, 2003, pp. 148-149). However, Enron was contractually bound not to sell its investment in Rhythms before the end of 1999 (Fusaro & Miller, 2002, p. 133).

Owing to this obligation Enron could not sell the shares for next few months, as the lock down was to end in October,1999 (Fox, 2003, p. 159), but its MM Model of accounting allowed it to book the huge gain resulting from the soaring market value of its investment in Rhythms (Fusaro & Miller, 2002, p. 133). Skilling was aware that if Rhythm's share prices went down, Enron would be required to adjust the value of the investment, as per the MM Model. Skilling wanted to hedge Enron from the risks associated with the investment in Rhythms (Fox, 2003, p. 149). However, it was hard to find a third party to hedge this investment for a value suitable to Enron, firstly because Enron had a very large block of investment, and secondly Rhythms' business of technology was considered very risky by Wall Street (Fusaro & Miller, 2002, p. 134).

Concurrently, Enron bought back its own shares from an investment bank under a forward contract. The transaction brought gains for Enron, as the market price of Enron stock was much higher than that which it paid under the forward contract. But accounting rules do not allow a company to register gains on buy back of its own shares as income. On this Fastow proposed the formation of an SPE named LJM1, with this appreciated stock, which would then hedge Enron's investment in Rhythms (Fox, 2003, pp. 149-151). Fastow proposed himself as the general partner, stating that his involvement in any new SPE was necessary to attract investors. Fastow's idea appeared to solve Enron's problem and Lay and Skilling agreed to present it to the Board (Powers et al., 2002, p. 68).

The proposal was presented to the Board in a special meeting of the Board of Directors. Lay called on Skilling to present the proposal for the formation of LJM (*Minutes of Special Meeting of the Board of Directors of Enron Corporation held on 28 June*, 1999). It was recorded in the minutes of the meeting that Skilling told the Board *"due to the changes in the accounting treatment of off-balance sheet transactions the company has been looking for new types of financing vehicles"*. He then asked Fastow to present the details of the proposal to the Board (*Minutes of Special Meeting of the Board of Directors of Enron Corporation held on 28 June*, 1999, p. 6).

Fastow started his presentation with a discussion of the problems faced by Enron, especially for hedging Rhythms. He further proposed to form an SPE named LJM1. He said Enron would transfer the forward contract it held on its own stock with an investment bank (as discussed earlier) and in return LJM1 would pay Enron $50 million and also hedge its investment in Rhythms (*Minutes of Special Meeting of the Board of Directors of Enron Corporation held on 28 June*, 1999). The minutes of the meeting do mention that there was some questioning by the Board on the proposal, which was answered to its satisfaction by Fastow, Lay and Skilling. The document does not provide details on the content of the questioning. Fastow also informed the Board that a *"fairness opinion"* (advice) from PriceWaterhouseCoopers (PWC) would be obtained to ensure the worth of the transaction for Enron and to establish the 'fairness' of consideration received by Enron. After the discussion the board approved the formation of LJM1 and also the involvement of Fastow in LJM. The board also gave Lay and Skilling full authority to decide whether the consideration Enron would receive in this transaction was satisfactory or not (*Minutes of Special Meeting of the Board of Directors of Enron Corporation held on 28 June*, 1999).

LJM1 was formed in June 1999 and Fastow raised $15 million from two limited partners to form this SPE. Enron transferred its 3.4 million shares valued at $276 million to LJM1, with some restrictions. It prohibited the sale/transfer of most of these shares by LJM1 for the next four years and also stopped LJM1 from hedging the value for one year (Fox, 2003, p. 152). Though LJM1 was formed to hedge the risk in Rhythms, the above details clearly indicate that there was no real hedging and that this was symbolic risk management.

It is not apparent what purpose it served for Enron to stop LJM1 from hedging its assets (Enron's shares), but Fox thinks that these restrictions were part of a larger plan, that helped Fastow to obtain a favourable opinion from PWC. According to Fox, these conditions allowed LJM1 to value the Enron stock at 65% of its full value. As a result Enron shares with a market value of $276 million were valued at $168 million, thereby requiring less payment by LJM1 to Enron. In return for Enron's shares, LJM1 provided Enron with $64 million in the form of a note and a put option valued at $104 million, on Enron's investment in Rhythms. The put option allowed Enron to sell its investment in Rhythms at $56 per share in 2004 (Fox, 2003, pp. 152-153).

However, the put option was not directly provided by LJM1. Fox notes that LJM1 sold some of the unrestricted Enron stock for $3.75 million and then transferred the money to another SPE called Swap-Sub along with 1.6 million Enron shares. It was Swap-Sub that provided the put option to Enron on its investment in Rhythms (Fox, 2003, pp. 152-153). In a way Enron was the only party involved in this hedging transaction and, in reality, there was no transfer of the risk and the company was protecting its investment on its own.

Fox believes that Swap-Sub was formed to protect Fastow's investment in LJM1 from any direct obligation in the event of a fall in Rhythms' value. Another important revelation by Fox is that Vincent Kaminski, who was the head of Enron's internal research group which operated as part of the Risk Assessment & Control Group (RAC), considered the LJM1 proposal "*stupid if not illegal*". He objected to the proposal by saying that it would be like Enron hedging its own assets. At that time his concerns were ignored but Skilling did take due note of his criticism. After the finalisation of the LJM1-Rhythms- Swap-Sub deal, Skilling informed Kaminski that he was transferred out of the RAC, owing to the multiple complaints he has received against Kaminski. In this way Kaminski was taken out of the loop involving LJM1 or any other similar transactions in the future (Fox, 2003, pp. 153-154).

At the start of 2000, Skilling decided to quit Enron's investment in Rhythms, primarily because the 'lockdown' on Enron, to not sell the Rhythms' stock, had expired in October 1999 (Powers et al., 2002, p. 87). Skilling could have made this decision, as soon as the 'lockdown' expired in October 1999 and it is not clear why Enron waited for another couple of months, especially when the uncertainties and risks (Fusaro & Miller, 2002, p. 134) associated with Rhythms' business were well known. It could be that Enron firstly wanted to record an after tax income of $95 million from Rhythms' stock (based on the MM Model) (Fox, 2003, p. 159) and then sell off the investment in Rhythms.

Once it was decided that Enron would liquidate its investment in Rhythms, it was necessary to terminate the hedging contract it had with Swap-Sub. Richard Causey (Enron'S Chief Accounting Officer) had the main responsibility for looking after the termination of the agreement and he contacted Fastow to decide the further process (Powers et al., 2002, pp. 87-88). Fastow, who was representing Swap-Sub, proposed to Causey that Enron pay Swap-Sub $30 million to terminate the deal. The proposal of Fastow was accepted, but this time no *'fairness opinion'* was sought by Enron, and there is no evidence of the Board being informed of this proposal (Fox, 2003, pp. 159-160; Powers et al., 2002, pp. 87-90).

According to Fox, even though the above proposal was not discussed with the Board, it was no secret for many at Enron. Fox reveals that, with time the number of Enron-employees doing business with Enron through an SPE was increasing (Fox, 2003, pp. 159-160). For example Swap-Sub was bought by Southampton L.P which was owned by Fastow along with some other employees of Enron, who contributed no more than $6000 each. However these employees received nearly a million dollars each in return, over a period of a couple of months (Powers et al., 2002, pp. 94-95).

4.11.2 LJM 2

Enron was increasingly using SPEs and soon after LJM1, it formed another SPE, named LJM2 in October1999 (Powers et al., 2002, p. 70). Before discussing LJM2, it is important to refer to the diversification happening at Enron, as in the year 1999, Enron aggressively pursued its asset light strategy. In May 1999, the company announced its plans to trade in bandwidth as a commodity, with a determination to revolutionise the internet industry (Fox, 2003, pp. 162-163). According to Fox, Enron acquired the idea from one of its executives, Thomas Gros who used to arrange video-conferences for Enron. He noticed that the company paid monthly rates for high speed bandwidth which it used for only a few hours on some days of the month. At that time companies used to deal in multiyear contracts to provide the internet, to cover for the high cost involved in building that network. The entry of Enron into telecommunications facilitated standard contracts of smaller amounts and the use of derivatives for those. Fox states that Enron began bandwidth trading in December 1999, and had an average start. Though the business was slow Skilling was quite ambitious and hopeful about the future of this project. According to Fox, bandwidth trading generated interest among a few other companies at that time who, like Enron, were very optimistic about it (Fox, 2003, pp. 164-165).

Enron created Enron on-line in November 1999, which brought an important change to its way of doing business. It was not only that Enron was a counter party to every trade, but also the list of items in which it started trading increased greatly. The company ended up dealing in 13 currencies and more than 1800 products. However, Enron did not enter into the areas monitored by the Securities Exchange Commission or by the Commodity Futures Trading Commission (Fox, 2003, pp. 168-171, 173-175; Fusaro & Miller, 2002, pp. 74-78).

During the same phase, Fastow proposed the formation of LJM2 to the Finance committee of Enron's Board. LJM2 would be a bigger company than LJM1 and would aim to attract $200 million or more from institutional private investors. It was also proposed that Enron would not contribute any forward contract/value towards LJM2. Fastow explained to the committee that Enron needed more of these types of SPEs to support its fund flow. He said that LJM2 could provide Enron with an optional source of private equity and it may buy assets from Enron to help it manage its investment risk and fund flows. He also informed the committee that he would be the general partner in LJM2, but would not participate in the general management of the SPE, since he held an important position at Enron. He further informed the Board that the Chief Accounting Officer (Richard Causey) and the Chief Risk Officer (Rick Buy) would review and approve all the transactions between Enron and the SPE along with an annual review of the transactions by the Audit and Compliance Committee of Enron. The committee did inquire about the roles of other partners, the review of the proposal by Andersen, the benefits of the priority given to LJM2 over any other investor and the role of Fastow, and later recommended the proposal for the Board's approval (*Minutes of Meeting of the Finance Committee of the Board of Directors Enron Corporation held on 11 October*, 1999). The Chairman of the Finance Committee presented the proposal to the Board citing the proposed review and control. The Board then approved the formation of LJM2 by Fastow (Powers et al., 2002, p. 72).

Fastow promoted LJM2, with the help of Merrill Lynch, as an "innovative financing strategy" of Enron and was successful in attracting $386 million from large institutional investors such as the American Home Assurance Company, First Union Investors, the State of Arkansas Teachers' Retirement System and Citigroup (Fox, 2003, pp. 177-178). With a strong financial base, LJM2 entered into various transactions with Enron, through the SPEs known as Raptors. These will be called Raptor transactions in further discussion. According to the Powers Report, Raptor transactions facilitated wiping off the merchant investment losses from Enron's books (Powers et al., 2002, p. 97).

Raptors

The first Raptor transaction was Raptor One (R1) which was formed in April 2000 (Fox, 2003, pp. 200-205). On the basis of information derived from Fox, the following diagram (Figure 4.2) presents the capital structure of R1.

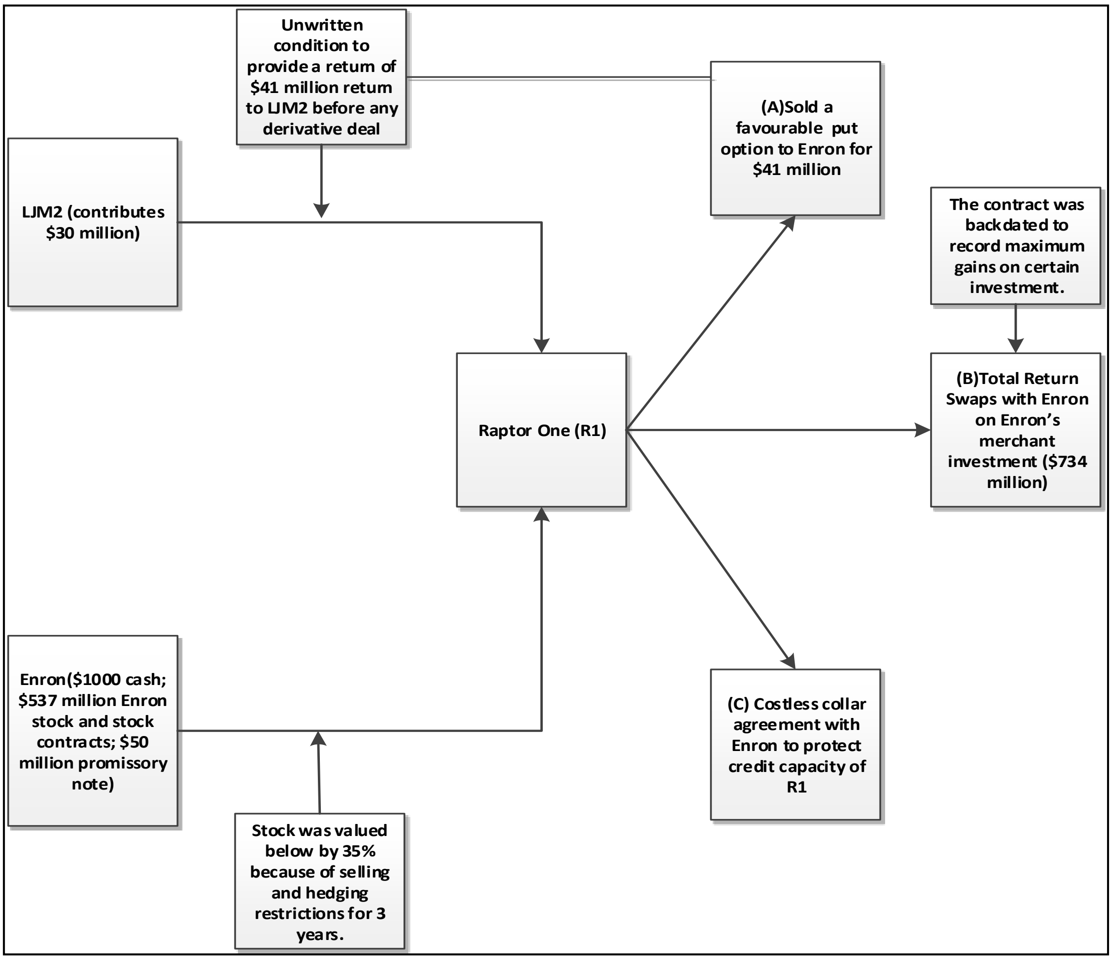

Figure 4.2 Capital Structure of Raptor One

The formation of R1 was followed by another three Raptors in the year 2000, over a span of few months (Fox, 2003, pp. 200-207; Powers et al., 2002). The Raptors helped Enron to boost its financial statements and, according to the Powers Report, Raptor transactions brought gains worth $500 million for Enron in the year 2000 (Powers et al., 2002, p. 119). However, towards the end of 2000, the Raptors themselves were in trouble. According to the Powers report R1 and R3 faced serious problems, especially due to the loss in derivative transactions with Enron. According to the report by the Permanent Subcommittee on Investigations of the US Senate, on the one hand, Enron's assets, which were hedged by Raptors, were declining in value and, on the other hand, Enron's own stock, which was the backbone of Raptors was in decline throughout the years 2000 and 2001(*The Role of the Board of Directors in the Enron's Collapse*, 2002, p. 44).

Enron was keeping a close eye on the developments in all the Raptors, owing to their significance in Enron's financial statements. Enron had various complicated transactions, as and when required, to save the Raptors, because their troubles would have negatively affected Enron's financial statements (Powers et al., 2002, pp. 110,119-124) as Raptors were primarily designed to make up Enron's financial statements (due to the ceremonial adoption of risk management practices). The following (Table 4.2) are the reflections from the Powers Report that show how effective Raptors were in polishing the reported earnings of Enron (Powers et al., 2002, pp. 132-135).

Table 4.2 (Contribution of Raptors in total reported earnings of Enron)

Quarter	Total reported earnings/losses ($millions)	Contribution of Raptors in total reported earnings/losses ($millions)
3rd, 2000	364	69
4th, 2000	286	462
1st, 2001	536	255
2nd, 2001	530	40
3rd, 2001	(210)	251

4.12 Sherron Watkins - The Whistleblower

Enron's increased dependence on SPEs was raising suspicion among many at Enron. However it was Sherron Watkins, an Enron Vice President and an accountant, who raised concerns about the high risk reporting practices of Enron. She sent a Memo to Lay in August 2001 stating *"Enron has been very aggressive in its accounting, most notably the Raptor transactions…… I am incredibly nervous that we will implode in a wave of accounting scandals." (Powers et al., 2002, p. 172).* She expressed the fear that Enron would end up facing losses to the extent of $500 million owing to the Raptor transactions. She also stated that Fastow was making money through these complex transactions at the expense of Enron (Behr & Witt, 2002a).

It is important to note that Skilling resigned from Enron in August 2001, just a few days prior to Watkins's memo, citing personal reasons (McNulty, 2001). After Skilling's resignation as the CEO of Enron, Lay became the new CEO of the company and he assigned Enron's legal counsel, Vinson & Elkins to investigate the matter raised by Watkins. It was a surprising move by Lay, since Watkins requested Lay not to involve Vinson & Elkins in this investigation as they were involved in many of the transactions suspected by Watkins (Behr & Witt, 2002a).

Vinson & Elkins submitted their report in October 2001 stating that "none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interests". They further stated that procedures meant to monitor LJM2 "were generally adhered to" and that all the transactions "were uniformly approved by legal, technical and commercial professionals as well as the Chief Accounting and Risk Officers" (Powers et al., 2002, pp. 175-176).

4.13 The Downfall

Even though this initial enquiry suppressed the issues raised by Watkins, Enron eventually ended up in trouble. After the September 2001 terrorist attacks on New York and Washington, Wall Street was affected severely, and so was Enron. Along with the fall in its share price, Enron was also worried about its over-reliance on LJM and Raptors. On 18 September, 2001, Enron's stock was trading at $28.08, and, if the share prices went to $20 or below, Enron and Raptors would be in serious trouble as Enron's shares were the major support that the Raptors had in terms of resources. It was a difficult time for Lay and Enron. Lay urged Enron employees to buy Enron shares "*My personal belief is that Enron stock is an incredible bargain at current prices, and we will look back in a couple of years from now and see the great opportunity that we currently have".* However not many were aware that Lay had used 556,055 Enron shares in August and September 2001, to settle the $20 million advance he had from Enron (Behr & Witt, 2002a).

By October 2001 the situation was no longer under Lay's control. On 16 October, Enron took an after-tax-charge of $544 million on its earnings, which reduced its after tax earnings by $544 million. This charge was due to the reporting gaps in Enron's dealings with LJM2. Within another month, Enron made another critical announcement - to restate its financial statements for 1997-2001, particularly due to the reporting errors in regard to LJM and Chewco (Powers et al., 2002, p. 2).

The restatement had a substantial impact on Enron. It significantly reduced Enron's reported net income and its shareholders' equity with a significant increase in its debt. On the basis of Powers et al. (2002) the following (Table 4.3) presents the impact of the restatement on Enron.

Table 4.3 (Impact of restatement of its reported earnings on Enron)

Year	Net Income before the restatement (in millions)	Reduction in Net Income (in millions)	Reduction in Shareholders' Equity	Increase in Debt
1997	$105	$28	$258	$711
1998	$703	$133	$391	$561
1998	$893	$248	$710	$685
2000	$99	$979	$754	$628

After the restatement Enron's share prices dropped further. At the same time, Lay was trying to save the company through a proposed merger with Dynegy (Robin & Rebecca, 2001); however Dynegy backtracked in the wake of the restatement and Enron filed for bankruptcy in December 2001 (Sidel, Herrick, & Schmitt, 2001).

Chapter 5

Case Narrative - Nathans Finance Ltd.

Following the advice of Pentland (1999) and DiMaggio (1995) this chapter provides a narrative to describe key aspects of Nathans' story that are important for the understanding of the context.

5.1 Background

Nathans Finance Ltd (Nathans) was formed in July 2001 as a wholly owned subsidiary of a vending technology company - VTL Limited[7] (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [7-10]). As a finance company, Nathans collected money from the public, mainly in the form of secured debentures (Gaynor, 2009). Nathans' experienced and well educated Board included Roger Moses, Mervyn Doolan, John Hotchin and Donald Young (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, pp., para [9]). Nathans was placed into receivership in August 2007 (Mace, 2011b) and its Directors faced charges in the court for breaches of the provisions of the Securities Act 1978 (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011). For the purpose of this research, Moses is the sub unit of analysis in the context of Nathans. The selection process has been explained in Chapter 3.

Moses (BCom, CFP, FNZIM, FINSTD) was the Chairman of Nathans. He was well known in the financial planning industry and was termed as the "grandfather' of the New Zealand financial planning industry" (Macalister, 2001), and had a wide range of experience in financial planning. He was the founder of New Zealand's first independent financial planning company, which was formed in 1972, and also strategically contributed to the formation and development of the Institute of Financial Advisers. Throughout his career he was involved in starting up many successful businesses as well as authoring or co-authoring several books on personal investment (*Castle Group Inc (CAGU:OTC US): Executive Profile*; *The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts- para [10]; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [111, 120]). This included Westgate Shopping Centre, the first open air mega shopping

[7] VTL was formed in 1997 and already had two subsidiaries, New Zealand Vending Management Limited and Vending Management PTY Limited, before the formation of Nathans (VTL, 2001, p. 10). It was listed on the New Zealand Stock Exchange in 2004. After the listing, Nathans' Director Roger Moses owned a 4.1% stake in VTL. Another two Directors of Nathans, Mervyn Doolan and John Hotchin each had 33.2%, and 25.4% of the shares were held by the general public. Another Director of VTL owned the remaining 4.1%. VTL operated in many countries and had vending machine businesses spread across New Zealand, Europe, North America and Australia (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [12]; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [7-8]).

centre in New Zealand, Calan Healthcare Property Trust, Strawberry Fields Childcare, and a number of successful fixed interest products (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [111]). He also served as the Director of VTL Group, Grafton Investments, Triceps Properties, and Castle Group (*Castle Group Inc (CAGU:OTC US): Executive Profile*)

Moses was also active on the social front, serving on various distinctive bodies including Plunket New Zealand, Institute of Directors, Chamber Music New Zealand, the Auckland Cricket Development Foundation and the New Zealand Symphony Orchestra Foundation. He also had a long association with the Auckland Jewish community (Vaughan, 2012). Moses was well known among high profile people in New Zealand, as Barbara Moses (wife of Moses) put it: *"We had some high-powered support from some pretty amazing people, people who continued to stand by us, who came to visit Roger [Moses]. They included several retired judges"* (Vaughan, 2012). Before the downfall of Nathans, Moses faced a court trial in 2001 as the Director of Reeves Moses Hudig (a finance company). The company was accused of being in breach of the law when lending money. It raised money from the public to finance a residential development in one particular suburb of Auckland. However the company used part of the money for financing property in another suburb without the knowledge of the contributors (Bond, 2011b). However, Moses was acquitted by the Court and was awarded costs (Bond, 2012; McManus, 2001).

5.2 Birth of Nathans

Nathans was a wholly owned subsidiary of VTL and was formed to provide financial support to VTL in terms of liquidity and working capital. It is interesting to consider why VTL preferred to form a finance company instead of arranging finance from banks or other financial institutions. VTL, which was incorporated in December 1997, was not listed on the New Zealand Stock Exchange at that time. It was operating primarily on the basis of its intellectual property and did not have enough tangible assets to provide as security to banks or financial institutions (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011paras [7, 9]). VTL had a total tangible fixed assets of \$154,631 by the year ended 31st March 2000, and \$545,080 by the year ended 31st March 2001. These included motor vehicles, plant and machinery, office equipment and furniture. These assets accounted for 13.86% (2000) and 5.37% (2001) of the total net assets of the company (VTL, 2001, pp. 13, 17). But VTL needed finances to utilise its *“proprietary technology - Smart Vend”* (VTL, 2001, p. 4) and *“to be a global licensor” (VTL, 2002, p. 19)* of the technology.

VTL is of significance for this research as Nathans was VTL’s subsidiary and the majority of the funds financed by Nathans (as a finance company) were advanced to VTL. Nathans was formed with a capital contribution of $3 million from VTL, who also provided a loan of $8,539,760 to Nathans at an annual interest rate of 5%. In its very first year Nathans raised $3,856,500 in the form of debentures, secured through a floating charge on the assets, at an annual interest rate of 8.2%. Also in its first year Nathans advanced loans worth $13,331,415 to VTL and related parties. This was 99.7% of its total lending for the year (Nathans, 2002, pp. 7, 9, 10). VTL's business mainly included its franchising network and its other subsidiaries (finance companies). Nathans provided loans to VTL's subsidiaries as well as to its franchisees. For the purpose of this research the term 'VTL and related parties' includes VTL, its subsidiaries and other entities associated with VTL's business. Specific names of the entities are mentioned where and when required. Nathans also provided loans to the Directors of Nathans/VTL but these are mentioned and considered separately for the purpose of this research.

Nathans shared its Board with VTL as the Directors of Nathans were also the Directors of VTL at one time or another (Gaynor, 2009). Doolan and Hotchin had been Directors of VTL and Nathans since their incorporation, while Moses and Young joined VTL later on. On the basis of the data collected from legal proccedings (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [10]), the following (Table 5.1) presents the involvement of all the four directors with Nathans and VTL.

Table 5.1 (Timeline Indicating the involvement of Nathans' Directors with VTL)

Name of the Director	Date of joining as the Director of VTL	Date of joining as the Director of Nathans
John Hotchin	December 1997	July 2001
Mervyn Doolan	December 1997	July 2001
Roger Moses	May 2004	August 2003
Donald Young	December 2006	September 2005

Along with the above four, VTL had one other Director - Gary Stevens [8]. He was the only one who was not the Director of both the companies. However he was a regular at Nathans' Board meetings and participated in the strategic decisions of Nathans. Stevens was close to Moses as they had some common business interests (outside VTL/Nathans) and they shared a suite of offices. It is interesting to note that Moses and Young joined VTL roughly around the time when Doolan and Hotchin were

[8] Gary Stevens was the only Director of VTL who was not on Nathans' Board. However he was a regular at Nathans' Board meetings and participated in the strategic decisions of Nathans. He was described as the "boss" and "shadow Director" by one of the Directors of Nathans. Stevens had other common business interests with Moses. He also shared a suite of offices with Moses. Moses had regular interaction with Stevens who was actively involved in running VTL (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paraS [11, 122]).

spending most of their time overseas (during 2004 and 2005) (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [10, 11, 122]).

VTL and Nathans not only had common Directors but common senior management staff as well. For instance the Chief Financial Officer of VTL, Ms Grant, also managed important aspects of Nathans's business. These included risk management, regulatory and legal compliance, and reporting and disclosure practices. It appears that she was not formally appointed by Nathans and mainly reported to the Board of VTL. VTL's Investment Services Manager - Ms Short, also worked for Nathans. She mainly looked after investor retention and liquidity management of Nathans (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011 paras [127, 130-132]). Even though Short reported to the Investment Committee and the General Manager of Nathans (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011 para [132]) there was no evidence of her assuming a formal position at Nathans, rather in the post-failure legal proceedings and in print media reporting she was referred as an employee of VTL (Mace, 2011c; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011; "Witness outlines attempts to retain 75pc of Nathans investors," 2011).

It was observed during the post-failure court hearings, that at all relevant times the only senior manager employed by Nathans was its General Manager. The General Manager reported to Nathans' Board and was responsible for monthly reporting and overseeing operations. The General Manager also chaired the management, credit and investment committees of Nathans. Despite holding such a crucial position, the General Manager did not have full access to *"the computer systems [of Nathans] containing information from the VTL side of transactions".* It is strange to note that the other common senior management staff, who had not been formally appointed by Nathans, did have access to this information. Of further note is that all of the VTL and related party transactions were handled by the staff who worked for both Nathans and VTL. Hence there was a conflict of interest involved (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [127, 128, 138]).

As stated previously, Nathans was the wholly owned subsidiary of VTL, but the level of control VTL had on its operations was certainly a cause of concern, especially considering VTL and its related party lending. The following sections discuss the other significant issues at Nathans that originated from its transactions with the parent company.

5.3 Risk Management and Credit Aprroval

5.3.1 The Risk Management Policy

In the 'Credit Risk' segment of its Annual Report for the year 2002, Nathans stated "Five of the six largest finance receivables arose from the sale by Vending Technologies Limited of regional agencies in NZ and Australia. These five finance receivables account for 60.4% of total finance receivables" (Nathans, 2002, p. 13). It was not a very clear statement and did not reflect clearly the VTL and related party lending (as some of the VTL related lending was termed as "Intercompany advancing" and some as "Finance receivables"). However, Nathans did have concerns about the related party lending as a highly concentrated lending portfolio could have affected its market credibility very badly.

As a result, in May 2004, almost three years after its incorporation, Nathans developed and adopted a risk management policy. Along with defining the role of the directors and the senior management team in managing the business risk, the policy also addressed issues such as the lending limits and concentration of lending. The adoption of the risk management policy reflected the concerns and actions of the Board to manage Nathans' risk, such as the concentration of lending and the adequacy of security for money financed by Nathans. It is important to note that, despite the significance of policy in defining the roles of Board members in risk management, Nathans' Board did not amend the policy after Young's arrival (as a Director) in 2005 (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [128, 144, 145]).

Concentrated Related Party Lending

The risk management policy required that *"No one Borrower or Borrower Group shall comprise more than 10% of [Nathans] total receivable book at any point in time".* At the time of issuance of the policy, Nathans had borrowers who were well over the 10% limit and the Board committed to reduce the concentration and bring it well under the limit of 10% by 30 June 2006 (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [144, 154, 162]).

Another important decision that Nathans took in 2004 (after the adoption of the risk management policy) was to achieve (by June 2006) *"a target composition of the receivables book ………… 33% commercial receivables and 66% VTL related receivables" (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [146]).* The lending diversification was certainly a cause of concern for Nathans. However Nathans only *claimed* to follow a diversified lending policy (Field, 2011), whereas in reality it neither followed its risk management policy nor did it reduce its lending concentration. Throughout its life it advanced a major part of its lending portfolio to VTL and related parties (*Report to Investors*, 2007). This shows that the risk management policy was merely ceremonial in nature and was never truly adopted in practice. This was a practice that Nathans continued from its very first year; however this study focuses on the lending concentration after the adoption of the risk management policy, because there is no other benchmark to compare to and there was limited data available in this regard. On the basis of the information drawn from the post-failure legal proceedings (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [154-160]) the following (Table 5.2) suggests that Nathans failed to control/minimise its VTL related lending.

Table 5.2 (Increase in VTL and related party lending after the adoption of the risk management policy)

Period ending	Financing to VTL related franchises	Financing to VTL and its subsidiaries	Total financing to VTL and related parties
30 June 2005	$35.46m	$60.78m	$96.24m
31 December 2005	$35.71m	$73.63m	$109.34m
30 June 2006	$36.47m	$79.63m	$116.1m
31 December 2006	$36.97m	$95.28m	$132.25m
30 June 2007	$37.24m	$103.63m	$140.87m
31 December 2007	$37.49m	$108.50m	$145.99m

It is important to note that Nathans' annual financial statements do not classify VTL related franchises as "Intercompany advance" (a term used to refer to VTL related lending). Since the notes to the financial statements do not provide adequate details to figure out 'VTL and related party lending' (as defined for this study), details from the court's decision are given preference over the annual statements of the company in this case study.

Table 5.2 confirms that, despite the risk management policy, the VTL and related party lending increased significantly. However most of this increase was due to the lending to VTL and its subsidiaries only. The VTL and related party lending were not only increasing in terms of total dollars, but also in proportion as compared to other commercial loans by Nathans. There had been a steady decline in the proportion of commercial loans to other entities by Nathans, from 22.5% of the total loans as at 30 June 2006 to 16.2% by 31 December 2006. By June 2007 they were reduced to merely 15.1% of the total lending (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of*

Heath J., 2011, paras [154, 162]). Due to lack of availability of data it was not possible to calculate the percentage for the year 2005.

5.3.2 The Credit Approval Process

As with any other finance company Nathans also had a rigorous credit approval process that required the sourcing of credit reports about the clients and valuation of any pledged security and cash flow assessments before the sanctioning of loans. However the process was only applied to third parties (other commercial loans) and not to the VTL related lending (Mace, 2011e). This segmented adoption indicates that the company was using the credit approval process more as a symbolic gesture of compliance rather than for managing the risk.

As per the risk management policy "Approval of new or increased credit exposures that were less than $1,000,000 required the approval of the Nathans' General Manager and any one of Nathans' Directors, or his designated nominee. [And the] approval of new or increased credit exposures greater than or equal to $1,000,000 required the approval of Nathans' General Manager and any two of Nathans' Directors, or their designated nominees." The General Manager was also given the authority to sanction loans up to the value of $250,000 on his own (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [144]). The importance of the role of the General Manager in the credit approval process is very apparent. However, as stated previously, Nathans' General Manager did not have access to the information related to VTL related financing, and VTL and related party loans/loan requests were handled by the common staff. This raised concerns that, as the General Manager of a finance company did not have full access to the information, it did not allow fair evaluation of loan/credit requests by VTL.

It is important to note that at times Nathans extended loans to VTL on top of approved limits. In some cases, even after the expiry of the loan facility, Nathans kept on advancing further loans. For example, Nathans increased VTL's credit limit from $13 million to $50 million in February 2005. Surprisingly at that time VTL already had a total loan of $44.2 million. Later on, after VTL's credit facility expired in August 2006, Nathans continued advancing loans to VTL, and renewed the facility only in February 2007 (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts- para [29]).

Adequacy of Security - VTL and Related Party Loans

As with any other finance company, Nathans's policies required adequate security against the lending. However, Nathans approved loans to VTL without proper security where either the realisable value of the pledged asset was less than the loan provided or no valuation of security was obtained. As far as lending to the Directors of VTL/Nathans was concerned, Nathans accepted VTL's shares as security against the loans (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [25]; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [147]).

In mid-2006, Nathans decided to draw up a 'General Security Agreement' with VTL. The agreement aimed to secure all the lending to VTL and its subsidiaries (excluding VTL's franchises). Nathans obtained an independent valuation of VTL's assets in this regard. The valuation was based on the discounted future cash flows for the next five years; however the forecast for the five years was provided by VTL, and did not reflect the true condition of VTL's business which was below the forecasts (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, paras [32, 33]; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [148]). The valuation process was merely ceremonial in nature. It was not only the valuation of the assets that was impaired, but Nathans' Board was also negligent in regard to the agreement. Nathans' 'Investment Prospectus - 2006' claimed that loans to VTL and its subsidiaries were secured against all the assets of VTL in general which indicates that Nathans' Board claimed to have the General Security Agreement in place, whereas the agreement was not registered and executed at the time of issuance of the prospectus but only became effective later (after an interval of a couple of months). This meant that during that interval Nathans financed money to VTL without adequate security and made false claims in the prospectus. (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [148, 149]).

Nathans also provided finance to the trusts linked to Hotchin (the McConnochie Trust), Doolan (the Boston Trust) and Stevens (the Milford Way Trust). The loans to these trusts were mainly secured against the shares of VTL held by these trusts (Doolan, Hotchin and Stevens had stakes in VTL through these trusts). However, considering the market value of the shares at the time of the loan approvals, the security provided by the trusts was less than adequate (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, paras [32-35]).

Since Nathans raised the major part of its funds through secured debentures, it was required to present a fair and clear picture in its investment prospectus. The 2006 prospectus admitted that Nathans provided *"significant financial accommodation to its parent company VTL and to VTL's subsidiaries".* But the prospectus kept the investors in the dark by stating that all the loans to VTL and VTL's subsidiaries were advanced *"on a commercial, arm's length basis, normally for terms no longer than 12 months"* (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts- para [27]). It is clear from the discussion in previous sections that VTL related loans were not subject to the same credit approval process as the other commercial loans, hence were not advanced on a commercial arm's length basis. Secondly the claim Nathans made about the 12 month period was also not true, as most VTL related loans were not subject to repayments; rather, Nathans allowed capitalisation of interest and rollover of loans. The rollover and the capitalisation are discussed in detail in the next session.

5.4 Rollover of Loans and Capitalisation of Interest

In conjunction with the previous section, the risk management and credit approval processes followed by Nathans were faulty as Nathans did not approve all of its loans on a commercial basis. However it is not only about the approval of these (VTL and related party) loans, but also about the way they were managed later on. As with any other finance company, Nathans should have required regular repayments towards the principal and interest accrued, but Nathans allowed rollover of loans and capitalisation of interest to VTL and related parties and to the trusts associated with its own or VTL's Directors. Before discussing the rollover and capitalisation, it is important to understand the conflict of interests in this context.

5.4.1 Conflict of Interests

Nathans' operations were affected by conflicts of interests. On one side a large portion of Nathans' lending portfolio contained VTL related lending, and on the other side three out of the four Directors of Nathans (Moses, Hotchin and Doolan) owned nearly a 70% stake in VTL. According to Mace, VTL's loan requests were mainly put forward by Doolan and Moses, who acted as counter party to these loans. Most of the time the requests were made verbally, and the loans were approved through emails (Mace, 2011c). It has already been mentioned that Nathans did not follow the required credit approval process for VTL related loans, and the General Manager of Nathans had hardly any involvement in the approval of these loans. It is hard to understand how Nathans still claimed to have approved VTL related loans *"on a commercial, arm's length basis".* The lending to VTL related franchises was also classified as 'commercial lending' despite the franchises being *"inextricably"* linked to VTL. These franchises were also allowed to capitalise the interest by Nathans (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [152, 153, 217]). Clearly there was conflict of interests prevalent at Nathans that affected its lending concentration and recovery of the loaned money. Any claims that no conflict of interest existed were merely symbolic in nature and had no real relevance to Nathans' operations.

5.4.2 Cycle of Rollover and Capitalisation

According to Nathans' Investment Prospectus, loans to VTL and its subsidiaries were made for less than a year, whereas in reality these loans were rolled over at the expiry of each term (*The Queen v J.*

Hotchin: Sentencing remarks of Lang J., 2011, para [29]). Not only the Investment prospectus, but Nathans' financial statements also projected a similar scenario, where loans to VTL and its subsidiaries were classified as *"current assets"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [223]). Nathans' VTL and related party lending hardly generated any cash flow for Nathans so, as a result Nathans relied on fresh investment in its secured debentures and the reinvestment by existing debenture holders on the maturity of their investment (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts- para [60]).

As far as loans to the trusts associated with Hotchin and Doolan are concerned, some repayments were made by the two trusts at the beginning (2005). But later Nathans allowed capitalisation of interest, requiring no periodic payment at all. Actually in March 2006, Hotchin informed Doolan and Stevens of his intention to sell 250,000 shares of VTL (owned by McConnochie Trust) to meet the repayment obligations to Nathans. On this Stevens asked Hotchin not to sell the shares, rather he proposed to Doolan and Moses to allow the trust to capitalise the interest (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts para [35]). It is important to note that the loan agreement required interest-only monthly repayments and the principal was to be repaid at the maturity of the term (3 years) (Nathans, 2005, p. 11; *The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts- para [37]).

Nathans accepted the proposal and allowed capitalisation of interest for six months (28 February - 28 August 2006) without requiring any additional security. After the capitalisation of interest the loan balance, which was $1,115,357 in the beginning, reached to $1,189,218 in September 2006. However, Hotchin again requested another extension for the capitalisation, which was granted for a further year (September 2006 – August 2007). Following Hotchin, in January 2007, Doolan also requested capitalisation of interest for the Boston Trust, until the maturity of the loan in June 2008 which was also approved without any objection (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, Agreed statement of facts- paras [35- 38]). It is evident (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011) that Nathans was getting into a never ending cycle of rollovers and capitalisation which was going to badly affect its cash flows and liquidity.

Impact of Rollover and Capitalisation

Rollover of loans and/or capitalisation of interest was not a sound business practice for a finance company, and was bound to bring fatal results for Nathans. As the related party loans constituted a major part of Nathans' lending portfolio, it magnified the effect of these rollovers on Nathans' liquidity. Owing to these faulty practices, Nathans's cash flow was being squeezed (McManus, 2010) and it was relying on fresh investment for its liquidity (Nathans, 2006; *The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [66]).

As a result of the capitalisation of interest, Nathans had a negative operating cash flow. It was not receiving much interest but had to pay interest on its borrowings (mainly debentures). Nathans's Annual Report shows that for the year ended 30 June 2005 Nathans paid $7.8 million in interest to its investors and received only $2.4 million in interest. In the following year ending on 30 June 2006, interest received was $4.9 million in comparison to interest payments of $9.1 million (Nathans, 2006, p. 6).

Even though Nathans' net cash flow from financing activities decreased to $26.76 million (during the year ended 30 June 2006) from $49.47 million (during the year ended 30 June 2005), it did not mean that Nathans' reliance on the investment/reinvestment also decreased. For the year ended 30 June 2005, Nathans had issued debentures worth $59.27 million (82.99% of total cash inflow) as compared to $52.39 million (75.75% of total cash inflow) for the year ended 30 June 2005 (Nathans, 2006, p. 6).

In this context Nathans was really struggling to manage its cash flow and financing, particularly due to the rollovers and capitalisation. The only ray of hope it had was fresh investment and/or reinvestment and here Nathans needed to issue an investment prospectus to invite fresh investment. But the issue was that if Nathans presented the actual picture of its cash flows and financing along with its lending portfolio, investors would not be encouraged to buy its debentures. Nathans eventually chose to dress-up its investment statement and prospectus in a way that would mislead the investors by concealing the true state of financial affairs. Before focusing on the dressing up and fabrication of the statements and prospectus, the following section discusses the unjustifiable belief Nathans had in VTL's business model that resulted in misleading the investors.

5.5 Unjustifiable Support of VTL

As has been discussed in the previous sections, Nathans not only had a VTL related lending concentration, it also had a tendency to ignore its own policies and procedures to facilitate lending to VTL and related parties. It appears that Nathans considered VTL's interests as a priority, even in comparison to its own business interests. As a result its lending concentration grew beyond reasonable limits.

5.5.1 Unjustified Lending Concentration

VTL reported a loss of $9.8 million for the year ended on June 2005, followed by a profit of $2.3 million for the year ended on June 2006. However, for the next six months ending December 2006, it again had a loss worth $5.9 million (Gaynor, 2009). VTL was such a priority for Nathans that, despite the problems faced by VTL[9], Nathans took no steps to control or reduce the VTL related lending concentration. Rather its commercial lending decreased significantly. It is important to consider that in 2004 Nathans did set a target to increase its commercial lending so as to bring it up to 33% of the total lending. On the contrary, Nathans commercial lending decreased further and in June 2007 Nathans's commercial lending was 15.1% of its total lending (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [162]).

5.5.2 Other VTL Related Investment by Nathans' Directors

It has been discussed previously that Nathans' Directors had investments in VTL, and that Hotchin and Doolan owned a major and substantial stake in VTL through trusts related to them. These trusts made further investments to indirectly support VTL's business. For instance in 2005, All Seasons (in which VTL had an 18.9% stake (Robertson, 2009)) took a loan of US$6 million from a private US bank 'Brown Brothers'. This loan was later bought by another entity, HD Fund, as an investment in VTL, on the condition that Nathans's co-founder should be a party to the risk assumed by it. As a result, trusts related to the Nathans' Directors made an investment in the HD Fund. The deal was basically financed by Nathans as it provided loans to both the trusts for this investment (Mace, 2011g; *The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [34]). According to Doolan *''Halpern Denny had put money into All Seasons and wanted us [Nathans] to share in that, it was a commitment from us to do that'' (Mace, 2011g).*Though this investment did nothing to improve the lending concentration of Nathans it appears to be very significant for VTL, as it was meant to establish VTL's business in the US. Hotchin, who was the chairman of Nathans at that time, resigned to become the CEO of All Seasons (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [274, 275]).

5.5.3 Support for VTL

As mentioned above, many believed that Nathans' Directors had an unjustifiable belief in VTL's business model. Despite the problems at VTL they believed that VTL would stand back up one day, and Nathans kept on providing financial support to VTL (Chaplin, 2011; Gregor, 2011d; "Nathans

[9] VTL reported a loss of $9.8 million for the year ended on June 2005, followed by a profit of $2.3 million for the year ended on June 2006. However, for the next six months ending December 2006, it again had a loss worth $5.9 million (Gaynor, 2009).

Finance documents divorced from reality, court told," 2011). For example in mid-2006, VTL struggled to repay Nathans and Chancery (its other finance company) and Nathans' Board was well aware of this (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011). Towards the end of 2006 Chancery was in a serious liquidity crunch with its third party debts maturing very soon. VTL approached Nathans for more finances so as to repay Chancery's investors on time. Nathans provided at least $1.75 million to VTL for that (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [156]). At this time Nathans itself was facing a shortage of cash flow as it was not receiving repayments from VTL and, as a result, Nathans had no option but to rely on fresh investment to keep its business running (Gregor, 2011d). Many times Nathans provided instant financing to VTL without inquiring into the intended use of the money. Sometimes, VTL used that money to pay for its operating expenses (Anderson, 2011a).

5.6 Fabricated Statements

To sum up the previous discussion, Nathans was borrowing money (as debentures) and lending it to VTL and related parties, followed by the rollover of the loans and capitalisation of interest. Hence Nathans was in financial trouble and since fresh investment in the form of debentures was the only way to keep operating, Nathans was worried about its image among the investors. To maintain a positive image, Nathans provided inaccurate information in its investment prospectus and related statements. For instance a prospectus of Nathans registered in 2006 provided false information related to crucial aspects of its activities. It presented a manipulated picture of its financial situation by presenting vague and or untrue information related to the bad debts, lending diversification, liquidity, and the related party lending. Nathans continued to deteriorate financially after the issuance of that prospectus, but the Directors of the company stated that there had been no materially significant change in the position of the company and extended the prospectus in March 2007 without any changes (Mace, 2011h).

There is evidence that Nathans used ambiguous and soft wording in the risk section of its prospectus to woo the investors which was done at the particular direction of Hotchin. He contended that if the market got to know the full extent of VTL related transactions, it would destroy Nathans' future prospects. Though Nathans' solicitors opposed the move, Moses gave his approval stating that the company should admit the issue of intercompany lending so that it could appear to meet the legal requirements, but should not harm Nathans' interest (Anderson, 2011a) . The investment statement in the prospectus included a letter by Moses, as the Chairman, in which he talked about the nil bad debt record of Nathans, its persistent profits, strong credit assessment process, and vigorous corporate governance. The letter also stated that Nathans' growing lending was in wider and more diverse commercial entities (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of*

Heath J., 2011). The Securities Act 1978 requires the issuer of financial instruments/securities to provide specific information to potential investors. In New Zealand this investment statement is an important document, which assists and informs interested public in the investment decision (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011).

The positive statements by Nathans kept the public in the dark about the risky investment path it was following. It created a false impression about the diversification of its lending and made the investors believe that the company had spread its loan portfolio among divergent fields. This was totally opposite to the actual situation, as VTL and related parties were the main constituents of Nathans' lending. The statements issued by the company reaffirmed to the audience that Nathans held an impeccable record of no bad debts and that it was a cautious lender (Gregor, 2011e).

Most of the questions about Nathans' prospectus were raised after the company went into liquidation, but Nathans' Board was warned of the irregularities in the prospectus long before that. The Securities Commission had concerns about Nathans' 2005 prospectus and sent a letter raising these concerns to Nathans in March 2006. The Commission stated that Nathans' statements did not provide a clear picture of the proportion of its lending to VTL and other parties and asked Nathans to provide detailed information about its lending in its documents. In response Nathans replied *"We consider that Nathans' exposure to its parent is covered in both the section 'Activities' and …….. in the section 'what are my risks?"* . It was stated that Nathans did not specify the quantum of VTL related debt as it would have fluctuated over time. Nathans in the reply stated "*We do not consider ……….. any money paid in consideration of the securities is received on behalf of VTL. Nathans is a separate entity, with a separate board of Directors……. It is not the agent of its parent and any inter-group lending is done on an arms-length commercial basis"*. Even though Nathans failed to operate as a prudent finance company, the reply it sent to the Commission reflected that it was well aware of the expectations of a prudent finance company (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [165, 166]).

5.7 The Downfall

By 2007 Nathans was in deep trouble especially in terms of its fund flows. Nathans' Directors were well aware of these issues and , in early 2007 Nathans unsuccessfully tried for a merger with another finance company so that the combined loan book would help Nathans improve its lending concentration (Mace, 2011f). In July 2007 one other New Zealand based finance company, Bridgecorp, went into receivership, causing investors to look at other finance companies. The last thing Nathans wanted was to lose was the faith of investors so Moses was quick to control the situation with an extremely positive letter to the investors of the company stating: *'All our loans are* *secured. We do not have any unsecured loans. The security for our loans is normally in the form of a first charge over the assets of the borrower or over real property, as well as personal guarantees, where the borrower is a company."* (Gaynor, 2009).

In the meantime, Nathans was subject to an inquiry by the Companies Office into its Prospectus and related statements. The investigation found Nathans was technically insolvent and it was placed into receivership owing $166 million to nearly 6000 investors (*Collapse increases investors' anguish*, 2007).

Chapter 6

Combined Findings

This chapter presents the findings of this thesis. It answers the research questions and presents the findings in terms of corporate governance functions, decision processes, and value orientation (a context identified and summarised in Chapter 2). The findings for both the organisations are presented on the basis of replication logic (Yin, 2009). Section 6.1 presents information about the first perspective- corporate governance functions, Section 6.2 relates to the decision processes, and Section 6.3 presents the findings related to value orientation.

As stated in Chapter 3, this chapter also briefly narrates the data analysis process, so as to enhance the understanding of the findings. Further details on the use of NVivo and its query tool are also provided in the chapter. The details on the NVivo query are supplemented by Appendices A and B. The chapter also provides direct quotes and narratives from the data to support the findings.

The findings are presented in the following sections.

6.1 Corporate Governance Functions (Input)

The study primarily aims to explore the role of corporate governance in corporate failures. Hence the researcher started with exploring the corporate governance content (functions) of the selected cases. For the purpose of this research corporate governance comprises setting strategic direction; formulating policy; managing and controlling risk; selecting the CEO and Directors; and monitoring performance.

Based on the above functions of corporate governance, the researcher had a ‘start list’ which included the keywords for the functions of corporate governance. The start list is provided in Appendix A (Table A. 1).

Two separate NVivo projects were created for Enron and Nathans. NVivo-Enron had a total of 142 sources (documents), whereas NVivo-Nathans had a total of 95 sources. NVivo *text search query* was used separately for both the projects to extract the content related to each of the keywords. The *text search query* was set to find matches that included *exact matches* along with *stemmed words* and *synonyms* for each of the keywords. For the *text search queries* the coding context was purposely customised to ONE word. Once the query results were saved into the respective projects, *word frequency query* was used on each of the saved *text query* results to find the most frequent words.

Since the *text search queries* were customised to ONE word only, the word frequency query provided a frequency for the matches for each of the keywords.

For example, in the case of NVivo-Enron, the *text search query* for the keyword *strategy* generated a total of 637 text references from 76 sources. Since the query had a customised coding context of one word only, the outcome was an exact match or a stemmed word, or a synonym for the word *strategy.* Then the word frequency query revealed the frequency count for each of the matched words. It is important to note that the same process and criteria was used for the other concepts (to follow).

6.1.1 Setting Strategic Direction

The key word *Strategy* represented the concept of *Setting strategic direction*. In NVivo-Enron the *text search query* for the keyword *Strategy* generated 637 text references from 76 sources, whereas a total of 59 text references from 19 sources were generated in NVivo-Nathans. The results of the query are presented in Appendix B (Table B.1. 1, Table B.1. 2).

The findings revealed that for both Enron and Nathans, the word *strategy* had the highest count followed by the word *strategies*, whereas the lowest count was recorded for the words such as *scheme* and *scheme*s. The text references for the words *strategy* and *strategies* have been found most relevant in generating information related to the setting of strategic directions at both the organisations. However, in the case of Enron, the text references containing the words *scheme* and *schemes* have provided further insight into the concept of *setting strategic direction.* The following sections report on the findings.

Strategic Direction - Enron

In the case of Enron, it has been found that use of the "asset light" strategy has been the major shift in the strategic direction of Enron (Gillan & Martin, 2007; Healy & Palepu, 2003). It has already been discussed in Chapter 4 that asset light strategy shifted Enron's focus from physical assets to intellectual assets. Along with asset light, Enron also adopted a diversification strategy. *"It began by reaching beyond its pipeline business … to become a financial trader and market maker…."*(Healy & Palepu, 2003). This shift in the strategic focus of Enron was applauded externally (Swartz, 2001). However, the findings indicate that the applause was not about the diversification strategy itself, but the purpose it was designed to serve. At Enron, this aimed at increasing immediate returns. Enron also wanted to get rid of low-performing physical assets and the goal was to sell these assets and *"record the income as earnings"* (The Role of the Board of Directors in the Enron's Collapse, 2002, p. 7), which would bring a sudden jump in Enron's earnings.

This change in strategic direction of Enron had a significant impact on Enron's performance. Firstly, due to the asset-light strategy, "*income was rising but cash appeared low because the company was booking long-term profits"* (Barboza, 2002). This was in conjunction with the adoption of the MM Model, a concept discussed in detail in Chapter 4. On a further note, the findings indicate that Enron's reliance on this strategy grew over time and this became *"crucial to the company's future financing strategies"* (Barboza, 2002). Ultimately, with the combination of asset light diversification and the MM Model, Enron was performing well as far as its financial statements and share process were concerned, but internally the truth was most of the income/revenue it claimed never existed (details provided in Chapter 4).

Another significant strategy adopted by Enron was the use of SPEs. Findings indicate that *"complex SPE transactions"* were used by Enron *"to manipulate [its] financial statements"* (Batson, 2003a, p. 82). Enron used SPEs to keep its debt away from its balance sheet (Schepers & Gardberg, 2004). SPEs were used to *"avert the negative performance indicators"* (Arnold & Lange, 2004) thereby "*creating the illusion of earnings growth"* (Deakin & Konzelmann, 2003) and an increase in Enron's stock prices (Schepers & Gardberg, 2004). This misuse of SPEs "*had been endemic within Enron for several years"* (Deakin & Konzelmann, 2003) and was an important part of its business strategy (Deakin & Konzelmann, 2003; Gillan & Martin, 2007). The Enron board clearly supported the use of SPE transactions "*to make Enron's financial condition appear better"* (*The Role of the Board of Directors in the Enron's Collapse*, 2002, pp. 42-43). Some concerns were raised internally on the misuse of SPEs (Batson, 2003a, p. 44; Behr & Witt, 2002a); however, the continual and increased use of such transactions indicate that no attention was paid to such concerns.

Since, Enron's *"[executive] compensation structure depended heavily on the reported financial performance of the company*" (Batson, 2003a, pp. 91-92), the manipulation of earnings affected its employees (Cunningham & Harris, 2006). For the employees it was *" less about booking profitable deals or controlling the risk of deals- and more about booking as many of the biggest deals possible*" (Cruver, 2003, p. 80). In many cases *"the Enron officers appeared less concerned about making the correct or best decision, and more focused on finding some justification for their desired result".* For example, they searched *"for ways to avoid public disclosure"* and obtained "*professional opinions or advice merely as a necessary procedural step"* (Batson, 2003a, pp. 93-94).

To summarise, the findings suggest that Enron adopted various strategies to make its performance appear better and ended up becoming dependent on these to avert its negative performance indicators. In terms of strategies like MM Model and the SPEs, the company had more of a ceremonial compliance.

Strategic Direction - Nathans

In the case of Nathans, the findings are informative about the investment strategies of the company. These strategies were critical to Nathans' performance, especially due to the nature of its business. It has been found that there were shortcomings in the investment strategy adopted by Nathans and the first significant issue was that *its "current assets were considerably less than the liabilities ……. This is because [Nathans] has been borrowing short (0 to 24 months) and investing long (0 to 60 months)."* (Field, 2011). These gaps were certainly very critical for a finance company as they would affect its cash flows/liquidity and long-term viability. Another important issue was the *"the concentration risks stemming from the ratio of VTL business-related lending to the total of Nathans' receivables"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [146]). The majority of Nathans' lending was to VTL and related parties, which indicates the flaws in its investment policy as it significantly raised the concentration of Nathans's risk. It also indicates that Nathans's strategies were focused on the short term and primarily ignored the long-term impact.

It was not that Nathans was unaware of these issues and the impact these were bound to bring. Findings support that concerns were raised internally on resolving these issues.

> *Moses then added he was worried and asked, in another email, "isn't it time we started to refocus our efforts toward the longer term" (Field, 2011).*

Nathans took remedial steps (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [326-328]) to sort out these concerns such as an *"investment committee was created to review cashflow projections of both Nathans and VTL on a regular basis to ensure that an appropriate fundraising strategy is in place"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paraS [136-138]). Nathans also set targets to improve its commercial lending and reduce its VTL related lending (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [146]). However, no significant attention was paid to implementing these suggested strategic changes (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [331]). There is evidence that Nathans was pinning its hopes on VTL, to revive its business performance.

> *"'the directors' actions were closer to blind faith as opposed to hopeless optimism'……….. '[Nathans] was pinning its hopes on a sale of VTL' …….. 'There was no reasonable basis for that view'……… 'There were no realistic prospects of a significant cash injection in the foreseeable' "(Chaplin, 2011).*

Nathans's divestment strategy to reduce its VTL related lending also failed, as the company went on to further fund VTL related acquisitions in the US. This resulted in *"an outflow of cash from Nathans (to fund acquisitions) rather than an inflow from a divestment strategy, on which the VTL directors had previously agreed".* This was certainly not a viable strategic move not only because of the already existing issues with Nathans's lending portfolio but also because at the time of these acquisitions *"it was clear that neither the IVL nor VTL debts to Nathans could be paid without VTL selling some or all of its American business units"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [286]).

It has been found that there were issues with the public disclosure practices of Nathans (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [146]). As a finance company, Nathans issued a Prospectus to raise funds from the public. However, despite being aware of inconsistencies in its strategies (and their implementation) Nathans provided misleading information to the public (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [432]). Along with poor external disclosure, Nathans' also did not have an internal free flow of information which would have affected the formation and implementation of its strategies. For example Nathan's General Manager (who was also a member of the investment committee) *"did not have access to computer systems containing information from the VTL side of transactions"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paraS [136-138]).

6.1.2 Formulating Policy

The concept of Formulating Policy is represented by the keyword *Policy.* In NVivo Enron the text search query for the keyword *Policy* generated a total of 880 references from 83 resources, and NVivo Nathans generated a total of 83 references from 18 resources. The results of the queries for both Enron and Nathans are presented in Appendix B (Table B.2. 1, Table B.2. 2).

The query indicate that the results of the text search query for both Enron and Nathans included words such as *policy, policies, insurer, and insurance.* However, keeping in mind the objective of this query (to find the content related to policy formulation at Enron and Nathans), words such as insurance, insured, insurer, insurable etc. were considered irrelevant.

Formulating Policy - Enron

The findings provide evidence that Enron had well-established policies (and procedures) to guide its actions such as:

> *[At Enron] comprehensive risk management processes, policies and procedures have been established to monitor and control these market risks (Enron, 1998).*

> *[At Enron] market risks are monitored by an independent risk control group operating separately from the units that create or actively manage these risk exposures to ensure compliance with Enron's stated risk management policies (Enron, 2000).*

> *Enron policy required the RAC Group to prepare a DASH [deal approval sheet] for every business transaction that involved an expenditure of capital by Enron. The DASH had to be approved by the relevant business unit, the Legal Department, RAC, and Senior Management before funds could be distributed (Powers et al., 2002, p. 90).*

The board was aware of the significance of these policies, for example, there were *"seven amendments [made] to the Risk Management Policy from December 1998 through May 2000"* (Batson, 2003a). Enron had also formed special committees in this regard, for instance:

> *The Executive Committee met on an as needed basis to handle urgent business matters between scheduled Board meetings ... The Finance Committee was responsible for approving major transactions …….. [it] oversaw Enron's risk management efforts; and provided guidance on the company's financial decisions and policies ………… The Audit and Compliance Committee reviewed Enron's accounting and compliance programs, approved Enron's financial statements and reports, and was the primary liaison with Andersen …….. The Compensation Committee established and monitored Enron's compensation policies and plans for directors, officers and employees (The Role of the Board of Directors in the Enron's Collapse, 2002, p. 9).*

However, the findings reveal the shortcomings in the policies adopted by Enron. For example, the risk control measures adopted by Enron were sufficient for managing *"true trading activities involving assets that have publicly quoted prices and substantial market [but] they did not allow the Board the opportunity to prevent the incurrence of debt through SPE transactions (structured as trading activities)"* (Batson, 2003a). It has already been discussed that SPE transactions formed a significant portion of Enron's trading activities. Thereby, Enron was risk prone owing to the gaps in its risk control measures.

On a further note, "under the Risk Management Policy, Enron or any of its subsidiaries [SPEs] could engage in a virtually unlimited amount of Prepay Transactions". This was a significant limitation of the policies adopted by Enron, especially when many of its SPE transactions if structured in a certain way did not require board approval. Moreover "if the Prepay Transactions were executed by a 75% owned subsidiary [SPE], the subsidiary's obligations could be guaranteed by Enron, all without obtaining Board approval" (Batson, 2003a). Granting such authority to the executives could be a good practice to have smooth operations but the problem was that "Enron's compensation policies engendered a myopic focus on earnings growth and stock price" (Gillan & Martin, 2007).

In this situation, the Enron board certainly needed to scrutinise SPE transactions, especially when Enron's interest was involved on both sides of the [SPE] transactions. Despite this "*the CFO was exempted [by the board] from conflicts of interest policy"* when he owned a stake in some of the SPEs (Cunningham & Harris, 2006). The Conflicts of Interests Policy of Enron prohibited Enron employees from being part of any such business deals. It was not only a matter of allowing an Enron employee to do business with Enron. The CFO was also representing Enron in those SPE transactions, thus allowing such exemptions was not in favour of Enron.

Further, the Audit Committee did not follow up on the "requirement for scrutiny having waived the Code of Ethics for Fastow [the CFO] despite its remit to review 'compliance with Enron's policies regarding business conduct'" (Tonge, Greer, & Lawton, 2003). Therefore it appears that Enron's "internal controls over SPEs were a sham, existing in form but not in substance" (Cunningham & Harris, 2006), and were merely ceremonial in nature. Such policies and practices of Enron were not without concerns, but findings indicate that due attention was not paid to such concerns, rather the issue was suppressed. When Enron received negative feedback/criticism for pursuing such policies, it exercised its power to suppress any such opposition. For example, the "Andersen audit quality partner who challenged some of the aggressive accounting policies [related to the SPEs] that Enron wanted to pursue was outflanked and eventually transferred" (Jr, 2002). The following quotes further confirm these findings:

> *Chung Wu an analyst at UBS Paine Webber, sent an email containing this warning to 73 of his clients: ' Financial situation is deteriorating in Enron…. I would advise you to take some money off the table….Waiting to make a decision would cost you a fortune." After a copy pf email landed at Enron, Wu's Bosses sent out the following correction: 'I hereby retract Mr. Wu's statements….. UBS Paine Webber has a strong buy recommendation on [Enron] stock." Wu was fired the same day "for violating the firm policy concerning electronic communications" (Fusaro & Miller, 2002, p. 72).*

Formulating Policy - Nathans

According to the findings, Nathans had established policies and procedures to guide its business operations. Nathans' credit policy addressed issues such as exposure to credit risk and it set limits on credit exposure.

> *"As part of this [credit] policy, limits on exposures with counterparties have been set and approved by the board of directors and are monitored on a regular basis." (Ruth, 2002).*

Nathans' risk management policy focused on managing its business risk. For example, according to the risk management policy *"No one Borrower or Borrower Group shall comprise more than 10% of [Nathans'] total receivables book at any point in time"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [145]). The risk management policy of Nathans also defined the roles of the directors and senior management team (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [128]).

As discussed above Nathans had policies to manage and guide its operations. However despite this, its lending portfolio had a risk concentration with most of its lending being VTL and related party.

> *Nathans Finance's concentration of lending looks decidedly risky. The prospectus notes that five of its six largest finance receivables (loans) were from selling Vending Technologies' master licences. These five parties bought licences and Nathans Finance lent them the money to pay for these (Ruth, 2002).*

A significant component of Nathans's risk management policy was that *"No distinction was drawn between VTL-related credit applications and those made by third parties"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [135]). It means that Nathans should have evaluated loan requests from VTL and related parties on the basis of its established policies. However, as discussed in Chapter 5, VTL and related party lending was never subject to proper scrutiny, rather sometimes the loans were approved without adequate security.

Findings further suggest that as far as VTL and related party lending was concerned, Nathans appears to have carried out policies according to the letter rather than the spirit (ceremonial adoption). For example:

> *Nathans' internal reports assumed that the loans to Advanced and Intelligent [VTL related parties] would be repaid on the due date, but it must*

> *have been reasonably obvious by [that time] …… that this assumption was unsustainable (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011, paras [43-44])*

Certain other issues have also been found in regard to Nathans' policies. For instance, Nathans' risk management policy defined the role of board members in managing its operations and related risks. It means that the policy needed amendments whenever there was a change in board membership. However *"No steps were taken to modify the policies when Mr. Young joined the Nathans' board"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [128]). Nathans' risk management policy also established a credit committee, but "the committee never met as a composite group in person" (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [135]). This indicates that Nathans did not pay due attention to its policies (and had a ceremonial adoption of those policies). Findings further reveal that even though policies were in place at Nathans, the directors appeared to lack a clear understanding of those policies. For example:

> *Despite the wording of this [risk management] policy, Mr. Moses gave evidence that he believed the 10% limit applied to VTL and IVL individually. That would have made the actual —prudent level 20% of Nathans total receivables book (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [146]).*

There were occasions where the Nathans board did not handle its policy matters adequately. For example, at the time of issuance of its investment prospectus the board failed to duly consider the risk section of the prospectus, so as to provide full and fair disclosure to the prospective investors.

> *This was, as Mr. Hotchin recognised in his email, a quintessential board issue. It involved a policy decision: to what extent do we emphasise risk? Had a meeting (or even a more informal teleconference) been held the directors would have turned their collective minds to the content of the risk section ………… An opportunity for the directors to ensure the —Risk section [of the Prospectus] was compliant was lost (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [185]).*

6.1.3 Managing and Controlling Risk

The concept of *Managing and Controlling Risk* is represented by the keyword Risk. The *text search query* for keyword *Risk,* in NVivo-Enron generated a total of 2132 text references from 95 sources, whereas a total of 176 text references from 33 sources were generated in NVivo-Nathans. The results of the queries are presented in Appendix B (Table B.3. 1, Table B.3. 2).

The results show that for both Enron and Nathans, the word *risk* and *risks* had the highest frequency. Words such as *chance, danger, risked* etc. had lower counts for both Nathans and Enron. The text references containing the words *risk* and *risks* were the most relevant in generating information related to the management and control of risk at both the organisations. However, in the case of Enron, the text references containing the words *chance* and *dangerous* have also provided useful insights.

Managing and Controlling Risk - Enron

Enron, in the beginning, focused on investment in physical assets, however, over time Enron, an asset- heavy company, transformed itself into an asset light company. In the process, Enron diversified into areas beyond its specialisation (Downes & Russ, 2005). During its life, many of Enron's much-vaunted ventures failed (Batson, 2003a). Enron used SPEs initially for legitimate business purposes but over the time it ended up misusing these entities and *"often budgetary and other basic controls were abandoned"* (Cunningham & Harris, 2006)

Evidence suggests that Enron misused SPEs (Munzig, 2003), hedge transactions, and Pre-Pay transactions to engineer its financial statements. For instance:

> *Although Enron treated these transactions as sales to SPEs for accounting purposes, Enron assumed liability for repayment of the debt incurred and retained substantially all of the economic benefits and risks of ownership of the asset (Batson, 2003a).*

In this way, Enron's financial statements appeared less risky as its non-performing assets were sold, but from the perspective of good governance, these transactions had no significance in terms of managing and controlling risk for Enron. The findings further indicate that:

> *Although the transactions were loans in economic substance, Enron reported its obligations as price risk management liabilities rather than debt (Batson, 2003a).*

Considering the above quotes, it appears that Enron's focus was on managing financial statements rather than achieving economic results and that the financial risk protection measures adopted by Enron provided virtually no economic protection to Enron. This is an indication of ceremonial adoption of the policies at Enron. The MM Model was also a major source of business risk for Enron.

Findings indicate that: *“The risk was enormous. If the market reversed, mark-to-market accounting required the recognition of losses, possibly enormous losses. A huge gap opened between realistic estimation of earnings and Enron’s estimations based on aggressive assumptions about interest rates, continuing viability of other parties to contract, taxes, regulations, technology, demand, etc”* (Cunningham & Harris, 2006). Despite the significant risk involved Enron went ahead with the use of the MM Model. It has been discussed in Chapter 4 that the model inflated the earnings of Enron, to mispresent the financial performance of Enron. Even after the adoption of the MM Model, there were concerns among the staff, which were basically ignored.

> *Of all of Enron's private investments, Mariner was the most overvalued ……………. Noting that the valuation model for Mariner was ``highly tweakable,'' another RAC employee says it was easy to inflate the investment by changing assumptions ………. two RAC employees say that when they complained about investment valuations, the head of their unit, Chief Risk Officer Richard B. Buy, rarely backed them up ("ENRON'S FISH STORY," 2002).*

Enron was a big organisation and had business dealings with third parties such as banks and financial institutions, and obviously, these third parties were interested in Enron’s performance. Findings indicate that Enron used its economic pressure to deal with any concerns raised by these third parties.

> *………… by using Enron's economic power, Enron officers were able to pressure third parties, such as financial institutions and Enron's professionals, to accommodate Enron's financial statement objectives. In many instances, this economic pressure appears responsible for overcoming concerns about reputational risk or other reservations by these third parties (Batson, 2003a).*

Many of Enron’s strategies were aggressive in terms of assuming risk. Enron’s recruitment strategy focused on hiring *“individuals with a risk-taking management style”* and training them *“to compete fiercely among themselves”* (Boje et al., 2004). Moreover, Enron’s compensation strategy further added to risky and aggressive business practices, and the focus was on providing an explanation to justify decisions rather than making a calculated decision to manage and control risk. *“Their primary concern seems to have been to ensure that they had an explanation if someone challenged their position, rather than to determine whether their decision was correct or was justified in light of the risks assumed”* (Batson, 2003a). The risk management and control practices appear more like ticking the boxes rather than actually managing the risk, *as “Many times Enron officers appear to have* *obtained opinions or advice from professionals merely as a necessary step to justify questionable decisions rather than as a tool to assist them in reaching a considered business decision based upon the risks"* (Batson, 2003a). Enron's employees were persuaded to take the risk so as to achieve the earnings growth and it monitored the risk in terms of a *"good deal vs bad deal".* A business deal was considered good if it had a positive impact on Enron's financial statements, and the significance in terms of strategic goals was hardly of concern here. For example:

> *"Enron's unspoken message was, 'Make the numbers, make the numbers, make the numbers—if you steal, if you cheat, just don't get caught. If you do, beg for a second chance, and you'll get one" (Elangkovan & Said).*

The way Enron handled the Valhalla trading incident (as discussed in Chapter 4), further supports the above findings that Enron monitored its operations in terms of the financial impact they brought to its reported earnings. It is worth noting that a considerable share of its reported earnings were actually never earned and were generated by using various accounting techniques.

On a further note even if Enron had measures in place to monitor its risk these were not applied thoroughly. For example Enron required its Audit and Compliance committee to review transactions with SPEs; however, these significant reviews were done as a mere formality. For example:

> *These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda . . . lasting ten to fifteen minutes (Benston & Hartgraves, 2002).*
>
> *None the less the board approved or acquiesced in several decisions with problematic features…., and were aware of Enron's recourse to questionable accounting. The record is replete with developments (such as an increase in revenues from $40 billion in 1999 to $101 billion in 2000) which would appear to have deserved more questioning by the board than they actually occasioned (Cornford, 2004).*

Managing and Controlling Risk - Nathans

As discussed previously Nathans developed policies to manage and control its risk and claimed to follow those rigorously. Despite that, Nathans's portfolio was ill-diversified, and towards the end, consisted primarily of dud loans, which indicates that the established policies to manage and control the risk of the company were not adopted. For instance:

By the end almost 80 per cent of Nathan funds were invested in dud loans to VTL - an unbelievable concentration of risk, a dereliction of diversification (Chaplin, 2011).

It was not that Nathans failed to manage and control its risk in terms of diversification, but findings also indicate that Nathan's lending to VTL and related parties was seriously flawed. It had a ceremonial adoption of policies related to managing and controlling risk. Nathans did not follow set rules and procedures to evaluate the risks associated with VTL related lending. For example:

Leong [Nathans General Manager] said the requests [for loan by VTL to Nathans] were usually verbal and the approval process involved nothing more than an email to one of the directors. There would be no individual risk assessment of the loans or a revaluation of the assets they had already been secured against, said Leong (Mace, 2011c).

…….. [Nathans'] lending to VTL was being rolled over without normal risk management practices being applied … (Smellie, 2011).

Available evidence indicates that Nathans' operations were significantly controlled by VTL, especially in terms of the evaluation of credit requests by VTL and related parties, which would have seriously affected its risk management and control practices.

…. [Nathans General Manager] said Nathans relied on the book value [of VTL'S assets held as security by Nathans] provided by VTL ….(Mace, 2011c).

The findings also suggest that Nathans did not allow free flow or at least adequate flow of VTL related information, to its staff. For example:

…. [Nathans General Manager] said he had no access to the parent company's financial information. In order to settle the loans VTL's CFO would work closely with Nathans accountant and effectively had control of the finance company's bank accounts, he claimed. Leong [Nathans General Manager] said he wasn't sure how the transactions were recorded on the companies' ledger (Mace, 2011c).

These findings indicate a significant problem with Nathans's risk management and control practices. It has been discussed in Chapter 5 that only the staff who worked for both VTL and Nathans had access to full information about the VTL related lending.

On a further note findings indicate that Nathans was constantly rolling over the lending to its parent company (VTL), which effectively brought no repayments to Nathans. Nathans' directors were aware of the severe financial problems that VTL and related parties were facing, however despite knowing VTL's inability to repay its dues, Nathans continued to financially support VTL and its related parties. The following quote indicates mismanagement of business risk at Nathans.

> *"From at least June 2006, the directors of Nathans knew that there was no reasonable prospect that the inter-company debt could be repaid without VTL selling all or some of its business units," …………….. "The loans could not be repaid out of revenue. The continual capitalisation of interest on loans to VTL demonstrated that not even that component could be met regularly out of income generated from VTL's businesses. "This information was relevant to the investment risk because it was directly linked to the possibility that VTL may itself, become insolvent." Yet the directors were rolling over the VTL loans and capitalising interest without referring them through the "robust" credit-checking process claimed in the Nathans prospectus (Smellie, 2011).*

Nathans was badly diversified, with poor risk management practices but still it managed to raise money from the public through its debenture issues. The primary reason for this was that Nathans did not disclose its risks clearly to the investors. It did not present the complete picture of its lending and related risks, in its investment prospectus. There were concerns raised by the Securities Commission on the issues related to disclosure.

> *…. [In the Securities Commission's letter to Nathans] Issues involving business activities and risk were raised: "We understand from the investment statement that Nathans was originally established to finance the activities of the VTL Group, and that it has since expanded into other commercial lending but is still significantly exposed to VTL. We query whether there is sufficient information given about this relationship to enable investors to properly assess the associated risks. In particular, it is not clear what proportion of Nathans' funds are loaned to VTL and other related parties. There also appears to be very little information about non-VTL lending and the industry or geographical sector- specific, or other, risks that may be associated with it" (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, paras [165-166]).*

It was necessary for Nathans to take some action to sort out the concerns the Commission had about Nathans. However, Nathans' directors tended not to resolve the issues, either by improving their risk management and control practices or by providing full disclosure to the public. For instance:

> *After liaising with Mr Doolan and other members of the prospectus preparation team, Mr Steytler proposed that the inter-company advances from Nathans to VTL be disclosed as percentages of the total loan book in the "Risks" section of the documents………. When Mr Steytler circulated those proposals he met with some resistance. The responses from directors reflected a very real tension between full disclosure to the public and the commercial imperative of "selling" the offer to the public (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, paras [170-174]).*

The following quotes indicate that the concerns raised by the Securities Commission were not duly attended to.

> *At one stage, Hotchin emailed his displeasure at a draft prospectus: "I strongly urge that the RISK section is changed as if this is going to market NO cash will come in" ("Damien Grant: Duties abrogated in murky world of second-tier finance," 2011).*

> *"The Risk section is a major concern, I agree with Roger this will create a big problem for capital raising going forward. We need to tone this down if possible." (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011, para [22]).*

The findings indicate that even the internal concerns raised to adequately address the issues raised by the Securities Commission, were ignored. At Nathans they did not manage and control risk by adopting such practices, but by controlling information and avoiding full disclosure. In this way the company was able to project (ceremonial) adoption of polices. For example:

> *….. "Looks ok to me. Do we have to address the credit concentration issue, do we have to make reference [to it] at all". General Counsel, David Steytler, …… replied: "It's part of disclosure of risks (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011, paras [19,20]).*

> *Mr Hotchin responded in strong terms: "I strongly urge that the RISK section is changed as if this is going to market NO cash will come in………. David*

[Steytler] you keep quoting our external solicitor as the driving force behind this, who is the solicitor and when did a lawyer take control of the decisions the BOARD make? I AM NOT HAPPY WITH THE RISK SECTION, IT NEEDS MODIFICATION URGENTLY. David, do not copy management on your reply. Please only address the DIRECTORS" (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, pp., para [181]).

6.1.4 Selecting CEO and Directors

The concept *Selecting CEO and Directors* is represented by two key words: CEO and Director; and two separate queries were used (First Keyword- CEO, Second Keyword- Director). The first query generated 692 text references from 80 resources for Enron, and a total of 91 text references from 26 sources were produced for Nathans. The second query provided 6638 text references from 112 resources for Enron, and a total of 1410 references were generated for Nathans from 90 sources. The results of the query are presented in Appendix B (Table B.4. 1, Table B.4. 2, Table B.5. 1, and Table B.5. 2).

For the keyword *CEO*, NVivo Enron generated text references containing words such as *CEO, CEOs, Chairman,* and *CFO;* whereas NVivo Nathans produced text references containing the words *CEO, Chairman, President* etc. In the case of Enron, text references containing the words *CEO* and/or *Chairman* were found to be relevant; and for Nathans text references containing word *chairman* were found to be relevant. For the second keyword, text references containing the words *management, directors, directorates* and/or *director* provided relevant information about the selection of key people at Enron; whereas text references containing the words *directors* and/or *director* provided insight into the selection of key people at Nathans.

Selecting CEO and Directors - Enron

The findings indicate that both Lay and Skilling played an important role in envisioning the future of the company. According to the annual report of the company *"ENRON CHAIRMAN AND CEO Kenneth L. Lay …. and President and CEO Jeffrey K. Skilling share a vision for positioning Enron as the leading energy provider in markets that are undergoing deregulation and privatization"* (Enron, 1998). Lay was part of Enron since its formation and he brought Skilling along later. Lay was *"……. so impressed with Skilling's talents that he created a new business division in 1990 to bring Skilling's leadership to the Company permanently"* (Arnold & Lange, 2004). It is important to note that Skilling as an outside consultant brought the idea of Gas Bank to Enron, and it was this idea that impressed Lay. These findings indicate that Enron's then CEO Lay saw an opportunity in the deregulation and privatisation of the energy sector and was determined to bring people on board who shared his vision.

The findings provide evidence that Enron's board comprised mainly outside directors and that all the board members were well qualified and experienced. For instance:

> *Of the 14 board members in 2001 only two were company executives (Chairman of the Board and former CEO Kenneth L. Lay and President and CEO Jeffrey K. Skilling). The remaining 12 outside directors included five CEOs, four academics (including economist Wendy Gramm — former head of the Commodities and Futures Trading Commission, Robert Jaedicke—a former Stanford accounting professor, a professional investor, and a former U.K. politician. Only three of these directors were viewed as affiliated—Belfer (the former president of Belco Oil and Gas which was acquired and became an Enron subsidiary),Wakeham (who also acted as a consultant to Enron on the U.K. utility industry), and Winokur (who had business dealings with Enron) (Gillan & Martin, 2007).*

Enron's board members also served on various committees such as executive, finance and audit committees. Enron had almost no changes in the memberships of these committees and it was found that *"… not only was there almost no movement among committee membership, the executive, audit, compensation, and finance committees were chaired by the same directors since 1995. Only the nominating committee changed chairmanship during this time, due to Director Walker's departure from the board"* (Downes & Russ, 2005). This indicates a long term consistent team. Moreover, both Lay and Skilling held important positions at Enron for the majority of the life of Enron. *"Lay was Chairman and CEO, and Skilling was President and COO ……. For a six-month period, from February through August 2001, Skilling held the position of CEO and Lay continued as Chairman. In August 2001, when Skilling abruptly resigned all his positions with Enron, Lay resumed the role of CEO"* (Batson, 2003a).

Enron's CEO and Board members received a highly competitive remuneration. *"Lay's total pay package was almost $31 million—more than four times the compensation of the average peer firm CEO"* (Gillan & Martin, 2007). Furthermore *"Enron directors were among the mostly highly paid for their services, according to Pearl Meyer & partners, a New York compensation consulting firm"* (Ableson, 2002).

Technically speaking Enron had an independent board and, apart from Lay and Skilling, the rest of the board members were outside directors. However, Enron's board had conflicts of interests where its board members had interlocking directorships, and had also been providing other paid services to Enron and its management. Enron also made significant donations to the institutions that were related to its directors. For example:

Unfortunately, many of them [Enron's directors] had relationships with Enron and its management team that clouded their consciences. Directors, for example, were collecting fees from Enron for services rendered, and some were even on retainer for legal and consulting services. Any opposition to management may have meant forfeiting these lucrative contracts (Downes & Russ, 2005).

…… several directors who would otherwise be considered independent suffered from potential conflicts of interest by way of business arrangements, or the receipt of charitable contributions or consulting fees (Gillan & Martin, 2007).

………….. [The directors] were paid large sums by Enron for their consulting services. This creates a situation where board members are beholden to management, and thus may side with executives in order to retain their contracts with the company. The same may be true of interlocking directorates, and Enron had several. In fact, all Azurix Water company directors also sat on Enron's board, which may have provoked the temptation to "scratch each other's' backs." This is not surprising, as all board members had been nominated by management (Downes & Russ, 2005).

Frank Savage was a director for both Enron and the investment firm Alliance Capital Management, which since the late 1990's was the largest institutional investor in Enron …… (Munzig, 2003).

Enron made donations to groups with which directors were affiliated (Gillan & Martin, 2007).

Selecting CEO and Directors - Nathans

As stated earlier, Nathans was a subsidiary of VTL and provided finances mainly to VTL and related parties. The findings relate back to VTL, due to its significance (as discussed in Chapter 5) in understanding corporate governance at Nathans. VTL was the dream project of Hotchin who brought Doolan along, who shared his vision.

Hotchin said he and Doolan saw a huge global opportunity to roll the technology out. "I thought Doolan was a bright, intelligent man. I wanted to

> *do business with him. It dawned on us that there was a good opportunity." (Gregor, 2011b).*

Nathans' parent company *"VTL had a number of high profile directors. The company was chaired successively by John Collinge (former president of the National Party), Richard Janes (former Chairman of Wools of New Zealand Limited), Warren Larsen (former CEO of the New Zealand Dairy Board) and Gary Stevens"* (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [5]). Similarly, Nathans' board consisted of four well experienced and educated members. For instance:

> *John Hotchin, who before his VTL career was best known as the youthful managing director of Graphic Mirage Print back in the early 1990s …….; Donald Young, an accountant who was previously a founding investor in water cooler company Aqua-Cool ……..; Mervyn Doolan, who appears to have had few directorships or much of a profile outside his VTL role; and Kenneth (Roger) Moses, who is a former director of broker Reeves Moses, which ran failed contributory mortgage schemes(Robertson, 2009).*

Moses and Hotchin held important position at Nathans. *" Mr Moses became the chairman of the Nathans board around September 2005, after Mr Hotchin resigned from that position".* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [10]). Nathans had a long term stable board with the only change being when Young joined the board in 2005. Similarly, there was no change in the membership of the various committees formed by the board.

> *The risk management policy defined the roles of members of the senior management team and directors, as well as establishing a number of committees ………. Moses and Doolan deposed that this policy document remained in place for the balance of Nathans' trading life. No steps were taken to modify the policies when Mr Young joined the Nathans' board in September 2005 (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [128]).*

> *The management committee of Nathans comprised its general manager, the chief financial officer of VTL and one director of Nathans. Mr Doolan was the director who primarily fulfilled that role……………. [When Doolan reduced his commitment] No* ***director*** *substituted on the management committee for Mr Doolan ……….. (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [134]).*

The findings provide that *"All of Nathans' directors were, at one time or another, members of the VTL board"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [10]). And *that "[VTL] was controlled and managed by the same board of directors that governed Nathans*" (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [26]). This indicates a conflict of interest as Nathans was lending money to VTL especially when the directors were involved in the application process from both sides.

> *[VTL'S loan] requests usually came to Nathans from Doolan himself as a director of VTL (Mace, 2011c).*

The findings further suggest that Nathans' board controlled the access to VTL related information. Even its directors only got access to that information once they joined VTL's board. For example:

> *Mr Moses had access to all board papers for Nathans from his appointment as a director of that company on 11 August 2003 and of VTL, after his appointment to the board of that company on 4 May 2004 (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [408]).*

> *There were occasions, such as receipt of the MC Capital valuation [to assess the value of VTL's assets held as security by Nathans] in May 2006, when although he [Young] was told by Mr Doolan of the general outcome of the report, he did not receive a copy. Mr Young had the opportunity to consider VTL documentation after joining that board on 13 December 2006 (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [408]).*

The other conflict of interest was that some of the Nathans' board members also borrowed significant sums of money from Nathans through the trusts associated with them at terms and conditions favourable to them, e.g. rollover of loans (as discussed in Chapter 5).

> *Directors of failed Nathans Finance and its parent VTL successfully applied to the finance company for loans to trusts administered by their spouses in the two years before it collapsed (Mace, 2011d).*

> *The loans were given to the Boston Trust, with trustee Joanne Doolan, and the McConnachie Trust, with trustee Sally Hotchin. Both acquired interest-only loans of US$780,000 (NZ$1.1 million) for 36 months secured against directors' shares in VTL. The Milford Way Trust of Gary Stevens, former VTL*

> *chairman, also had a $75,000 loan which was rolled over to $125,250 for another 12 months from June 2007, records tabled in the court showed (William, 2011).*

Some of the directors also provided paid professional services to Nathans such as consultancy. For example *"Nathans has paid Moses Stevens & Associates Limited $15,000 in the twelve months to 30 June 2006 for consulting services provided by Kenneth Roger Moses"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [203]).

6.1.5 Monitoring Performance

The concept of *Monitoring performance* is represented by the keyword *Performance.* In NVivo-Enron the *text search query* for key word Performance generated 6445 text references from 76 sources, whereas a total of 690 text references from 19 sources were generated in NVivo-Nathans. The results of the queries are presented in Appendix B (Table B.6. 1, Table B.6. 2).

The results show that for both Enron and Nathans, the words *act* and *executive* had the highest count. However, neither of these words provided text references relevant to the concept of *Monitoring performance.* The text references for the word "performance" have been found to be most relevant in generating information related to the concept for both the organisations.

Monitoring Performance - Enron

In the case of Enron, the findings indicate that the company had a formal set up to monitor its performance such as the performance review committee (Arnold & Lange, 2004). It had a compensation plan based on employee performance to ensure that the employees were contributing effectively. For example Enron's Annual Report stated *"Enron subsidiaries maintain various incentive based compensation plans for which participants may receive a combination of cash or stock options, based upon the achievement of certain performance goals"* (Enron, 2000). The company had a Performance Review Committee (PRC) that monitored the performance of its employees (Arnold & Lange, 2004). The company also had established an RAC (Risk Assessment & Control Group) which monitored the performance of various departments of the company ("ENRON'S FISH STORY," 2002).

Further, the findings indicate that there were shortcomings in this system. The performance review system of Enron was *"known as the harshest employee-ranking system in the country"* (Arnold & Lange, 2004). Moreover, "*Enron's performance-review system gave dealmakers [Enron's trading departments] the ability to evaluate the RAC personnel who were reviewing their deals--a practice that made it risky to challenge aggressive investment valuations"* ("ENRON'S FISH STORY," 2002).

This was certainly a conflict of interest as RAC employees were supposed to assess and control the activities of these departments.

The findings suggest that Enron's only apparent performance measure was profit. Even though *"Enron based its employee values on the principles of respect, integrity, communication and excellence ……. employees soon learned, the only meaningful performance measure was the relentless pursuit of profit"* (Arnold & Lange, 2004). Similarly Enron's Annual Report states "Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance" (Enron, 2000).

"Enron's stated compensation philosophy was a pay for performance approach; those who were determined to perform well were paid well" (Schmitt, 2003). This, along with the harsh performance review system, appeared to have nurtured a tendency among Enron employees to go for risky deals, as the higher the risk the higher the chance of profit. For instance:

> *The tools put in place to promote management accomplishment within Enron, ironically grew to become the self-serving objective of management. Whilst information asymmetry grew, management appeared to escalate their risk taking efforts aware that this would enhance the perception of their performance with little chance of being exposed (Arnold & Lange, 2004).*

This further promoted some of the questionable practices at Enron, such as Enron using SPEs to hide its non-performing assets and also to create a positive impression in its financial statements.

> *Opportunistic strategies were also evident in the use of the SPEs. These were used to avert the negative performance indicators ………. (Arnold & Lange, 2004).*

It is important to note that even though Enron was successful in creating a favourable impression through its financial statements, internally the RAC was not satisfied with the performance of the company.

> *While the company boasted about the performance of its investments externally, a different picture was painted internally. According to Kose, executives at an RAC meeting told other members of the unit in the summer of 2001 that 70% of Enron's investments had failed to meet their internal performance targets ("ENRON'S FISH STORY," 2002).*

Despite having concerns, no significant steps were taken by the RAC to control these practices- this indicates the flaw in the performance review system of Enron. As RAC employees were evaluated by other departments, this might have stopped them from taking strong actions.

Monitoring Performance - Nathans

The findings indicate that Nathans claimed to have a robust system in place to monitor its performance. For example:

> *[Nathans's investment prospectus stated that] the Company has policies in place to ensure that all obligations are met within a timely and cost efficient manner, and prudential policies are regularly monitored. In addition, the Company monitors its liquidity ratios monthly against prior month and financial year performance (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [196]).*
>
> *[Moses said that] "Nathans Finance is in a unique position in that VTL Group's franchise operators have their business performance monitored electronically on a daily basis. This means that any business difficulties they are experiencing are picked up early, so immediate remedial action can be taken." (Solid Nathans Finance Results, 2006).*

The above findings indicate that Nathans not only claimed to have a good system to monitor its performance, but it also claimed to use its (or its directors) relation with VTL to monitor the performance of VTL related parties as to whom it has advanced loans. However, further findings reveal that Nathans' claims lacked ground, and that it failed to monitor the VTL and related party finance, thereby resulting in a significant deficit for Nathans (Gaynor, 2009).

There were shortcomings in the way Nathans was operating as a finance company. For example, the valuation of VTL's assets used by Nathans in the loan application process were based on the analysis provided by VTL.

> *The valuation relied, however, upon a discounted cash flow analysis based on a five year forecast prepared by VTL's internal management. The information available to Nathans' directors ought to have led them to conclude by December 2006 that it was not reasonable to rely on this valuation, because VTL's actual business performance did not match the forecasts upon which the valuer had relied. This fact should have led Nathans to treat VTL's loans as impaired, and it also called into question the*

> *validity of the valuation prepared seven months earlier (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011, para [33]).*
>
> *In preparing his valuation, Mr Cole-Baker relied on a 20 year budget for Intelligent prepared by VTL's management. The assumptions in the budget did not accurately reflect the past trading performance …. (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011, para [50]).*

These findings suggest that Nathans' board failed to take corrective action despite knowing the poor performance of VTL and related parties. Since Nathans' directors were also part of VTL, they should have knowledge about those issues. However, the findings indicate that Nathans' directors had biased attention and ignored those issues and Nathans continued to lend money to VTL and its related parties. For example, during the post failure trial the court noted that:

> *You [Hotchin] were prepared to overlook or ignore the fact that VTL and its associated companies were performing poorly. This was despite the fact that the financial information that was made available to you made that fact plain (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011, para [51]).*

It was found that rather than declaring the impaired debt (VTL and related party debt), Nathans disguised its negative performance. "*Nathans routinely rolled over impaired related party loans and capitalised the interest on them to create the guise of a performing asset in its financial statements." ("Nathans directors 'bedevilled by conflict'," 2011).* The company appear to have an intention of ceremonial compliance rather than adopting it in spirit. The findings provided evidence that "*non-performing loans, particularly related-party loans, were frequently rolled over and interest was capitalised. These loans were never transferred to the credit recovery team for ongoing management and recovery*" (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [58]).

It was further found that Nathans's had biased attention towards the concerns raised by external parties in this regard. For example, some of the franchisees of VTL raised concerns that *"the financial performance of the VTL entity was a long way from the financial projections that were forecast"* (Gregor, 2011a). Even the ASB Bank declined to grant a $5 million funding line, for Nathans due to the concerns it had about the financial performance of Nathans and VTL (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [341]).

6.2 Decision Processes

The study analysed the corporate governance decision processes on the basis of *'A Behavioral Theory of the Firm'* by Cyert and March (2001). The theory is based on four relational concepts, which are: Quasi Re**solution** of Conflict, Uncertainty Avoidance, Problemistic Search, and Organisational Learning. According to Cyert and March (2001) these concepts are the heart of the their theory. Based on these relational concepts, the researcher had a 'start list' to represent the corporate governance decision processes, which is presented in Appendix A (Table A. 2).

The study used NVivo to extract the findings related to the above four concepts. By now the researcher already had two separate NVivo projects for Enron and Nathans (as stated in Corporate Governance Functions). The same projects were further used to run *text search queries* and *word frequency queries* for the four relational concepts. The criteria for the use of NVivo was the same as discussed previously (under Corporate Governance Functions).

6.2.1 Resolution of Conflict (Quasi Resolution of Conflict)

According to Cyert and March (2001) an organisation is a coalition of members who have both similar and different goals. This leads to conflict among members so the organisation goes through the process of resolving those conflicts. Therefore, the focus of this query was on the way conflict was resolved at both the organisations.

The concept of 'Resolution of Conflict' is represented by the key words *Conflict* and *Resolve.* For the keyword, *Conflict,* the *text search query in* NVivo-Enron generated 2380 text references from 103 sources, whereas a total of 134 text references from 34 sources were generated in NVivo-Nathans. For the keyword, *Resolve,* NVivo Enron generated a total of 1914 text references from 109 sources, whereas NVivo Nathans generated 199 text references from 51 sources. It is important to mention that the query results from NVivo presented the starting point to the researcher. The researcher searched for further information, mostly surrounding those, to analyse the concept of 'Resolution of Conflict'. A similar approach was needed for the rest of the three concepts of the decision-making process. The results of the queries are presented in Appendix B (Table B.7. 1, Table B.8. 1, and Table B.8. 2).

In the case of Enron quotes containing the keywords *Conflict, Conflicting, Different, Engage, Dispute, Solution,* and *Difference* provided the key insights into the concept. Whereas in case of Nathans keywords *Conflict, Struggle, Difference, Dispute, Difference* and *Differently* provided the key insights.

Resolution of Conflict - Enron

In the case of Enron, the findings reflect various conflicts at Enron, such as its issues related to its accounting practices (Batson, 2003a), hedging transactions (Behr & Witt, 2002a), concerns regarding its use of SPEs (Batson, 2003a) and the role of Enron employees at various SPEs (Cunningham & Harris, 2006).

It has been found that there were concerns regarding the accounting practices the company had adopted. For example:

> *……. Andersen [Enron's auditors] partner David Duncan may have warned the Audit Committee of the risk that others could have a different view of Enron's aggressive accounting and disclosure (Batson, 2003a, p. 43).*

However, in their sworn statements to the court, the member of the Audit Committee denied having knowledge of the severity of the situation.

> *Indeed, multiple Audit Committee members have stated that they were not informed by Andersen of the magnitude of the transactions that involved "high risk" accounting judgments (Batson, 2003a, p. 43).*

The findings further indicate that by February 2001 Andersen was so concerned about these issues that it considered whether to retain Enron as a client or not[10]. Prior to that Andersen also made the suggestion to *"disclose the impact of the Prepay Transactions on the financial statements"* but did not pursue it further when Enron refused to make the disclosures (Batson, 2003a, pp. 44-45). It raises the question that if Andersen was so concerned about Enron's accounting practices why it never raised the issue strongly with Enron. Even the above-mentioned warning by Duncan was given orally only (Batson, 2003a, p. 43). The following findings support the lack of stringent action on the part of Andersen to raise or resolve this conflict.

> *In an internal February 2001 Andersen meeting regarding whether Enron should be retained as a client, the Engagement Team presented a slide prepared for its anticipated presentation to the Audit Committee that disclosed that the application of GAAP to Enron's structured transactions often requires "extreme" judgement. When Andersen made the actual presentation to the Audit Committee a week later, however, the word "extreme" was replaced with the word "significant" on that slide. The*

[10] Andersen remained Enron's auditor till the end.

evidence suggests that Andersen took a similar approach in other aspects of its presentations to Enron's Audit Committee, in which "accounting risk" and "disclosure risk" were described as a product of the complexity of Enron's business, when in fact that risk arose from the aggressive accounting techniques (Batson, 2003a, p. 44).

Along with accounting practices, Andersen had concerns regarding the use of SPEs by Enron. One of the internal emails at Andersen stated *"Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?"* (Batson, 2003a, p. 45). There is no evidence suggesting that these concerns were ever put forward by Andersen. One of the reasons could be that Enron was the biggest client for Andersen (Behr & Witt, 2002a) and Andersen did not want to risk losing that business. The findings indicate that even if the employees at Andersen raised concerns, Enron indicated its displeasure. For example:

Enron's Chief Accounting Officer, Causey, had requested that Andersen remove Andersen partner Carl Bass [who worked in a senior position at Enron (Schmidt, 2002)] from further participation in the Enron [when Bass objected to some of the accounting treatment at Enron (Schmidt, 2002)]" (Batson, 2003a, p. 102).

Commenting on Enron's ability to exert pressure on Andersen, one Enron in-house attorney commented: ……………. a very junior person at AA in London said no, that will not work …………………….. We will see if the junior person who has made this trouble is employed with AA after January 1st; however, very few people here are betting on that (Batson, 2003a, p. 102).

……. An Andersen employee, would later testify that she was told not to press her challenge to an Enron action. "It is what it is," she said a superior told her. "The higher-ups [at Enron] had already decided that it was going to be done." (Behr & Witt, 2002a).

It has been found that even internally conflicts were not duly resolved at Enron. For example, the RAC group at Enron disapproved of many of the practices at Enron such as hedging and SPE transactions (Behr & Witt, 2002a). The following quotes indicate the presence of such conflicts.

Kaminski had never liked Enron's strategy of using its own stock to hedge its tech investments in deals with …. [SPEs]. He thought the risk involved and

Fastow's conflict of interest created a situation where "heads the partnership wins, tails Enron looses." s (Behr & Witt, 2002a).

However, the RAC was unsuccessful in getting its concerns addressed. For example, the following quote indicates that despite RAC's concerns Enron did not adjust (so as to reflect the true picture) the book value of some of its investments.

Executives inside a key internal control unit, the Risk Assessment & Control Group, felt its [Mariner- one of Enron's investments] soaring book value was overstated, according to several ex-employees. They waged an unsuccessful war to have Mariner's value marked down ("ENRON'S FISH STORY," 2002).

Enron regularly discarded the analysis provided by the RAC, resulting in a kind of withdrawal by the RAC. For example: *"While the company boasted about the performance of its investments externally, a different picture was painted internally. According to Kose, executives at an RAC meeting told other members of the unit in the summer of 2001 that 70% of Enron's investments had failed to meet their internal performance targets. The summer meeting ``was supposed to be secret,'' says Kose. ``They purposely did not distribute any documents."* ("ENRON'S FISH STORY," 2002). The following quote further confirms these findings.

Many [RAC employees] say that they frequently complained about how their sophisticated financial analyses were discarded. So, out of frustration, they decided to take a different approach to valuing the company's outside stakes starting in early 2000. Rather than simply rubber-stamping the investment valuations proposed by the company's business units, as they had been pressured to do in the past, they decided to start offering valuation ``ranges'' for the company's investments. The range for Mariner, for instance, was $80 million to $350 million, according to one RAC source. ("ENRON'S FISH STORY," 2002).

This indicates that the conflict was not resolved, and RAC adopted the above approach to safeguard itself from related consequences. For example:

Little changed, though, as the company almost always took the highest possible valuation. But the RAC group believed it was making a point. ``If they were marking [the valuation] to whatever number they wanted for book purposes, we didn't want to be responsible for that number,'' says another former RAC manager ("ENRON'S FISH STORY," 2002).

Findings further indicate that some significant conflict issues, despite being known, were not given appropriate consideration. For example, the use of SPEs and the interest of Enron's staff in those SPEs were significant issues. As discussed in Chapter 4, there was a conflict of interest involved. However, the board appeared to have a limited discussion on such transactions. For example:

> *The special meeting lasted only an hour, and amongst the approval of the conflict of interest [in LJM transaction] were substantial topics such as resolutions authorizing a major stock split, changes in the company's stock compensation plan, acquisition of a new corporate jet, and discussion on an investment in a Middle Eastern power plant (Munzig, 2003).*

The above findings indicate that the board did not appear to challenge most of the decisions, nor was it dissatisfied with limited discussion on important matters.

> *Mr. Winokur admitted, however, that neither he nor any other Board member had inquired about who bought Mr. Fastow's interest in LJM, in order to verify that no conflict of interest remained (The Role of the Board of Directors in the Enron's Collapse, 2002, p. 34).*

> *Sworn Statement of Jerome J. Meyer, former Director, Enron, to Steven M. Collins, A&B, Aug. 29, 2003, at 45-46 ("Q. With respect to the board meetings, did you feel that the time that was allotted to the board meetings was sufficient for you to have all your questions answered about the matters that were brought before the board? A. Yes. I never felt like we were without time to address everything that needed to be addressed. I'm comfortable with that (Batson, 2003a, p. 133).*

Another significant finding regarding conflict resolution is the memo presented by Sherron Watkins to Lay, raising concerns and warning of severe implications, about accounting irregularities at Enron. Watkins requested Lay not to engage Vinson and Elkins, Enron's primary outside law firm, in the investigation because Vinson and Elkins participated in structuring those transactions. However, Enron asked Vinson and Elkins to investigate the matter (Brickey, 2003).

Resolution of Conflict - Nathans

In the case of Nathans, it is found that most of the conflict arose from VTL and related party transactions. It has been discussed in Chapter 5, that a large part of Nathans' lending portfolio consisted of VTL and its related parties. The findings indicate that it was not only the percentage and volume of lending to VTL and related parties that was the cause of concern, but also the falling financial performance of these parties (Gaynor, 2009; Mace, 2011a).

To resolve the VTL related situation, Nathans claimed to follow rigorous credit approval procedures for VTL and its related parties. For instance:

> *That impression is conveyed by statements that loans to VTL companies were made on the same basis as those made to arm's length third parties. An inter- company loan would be treated no differently from any other loan, with regard to payment of interest, repayment of principal and, if necessary, enforcement of securities (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011para [207]).*

Nathans's policies also did not differentiate between VTL related and third party lending. However, as far as the above claims of arm's length relations were concerned' *"the directors were aware of the cursory basis on which applications for finance and/or roll-overs were made in cases involving VTL, IVL, and AVS. The degree of scrutiny given to third party borrowers far exceeded those relating to VTL, IVL, and AVS …." (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011).* On a further note, Nathans also presented some of the VTL related lendings as commercial lending to improve its financial ratios. For instance, findings indicate that:

> *While the amounts owed by IVL and AVS were ………………. treated as part of the "commercial" lending [despite the fact that] ………… IVL and AVS were inextricably linked to that of VTL. (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011para [152]).*

The not so good financial position of VTL and its related parties affected their repayments to Nathans (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011). To resolve the situation, Nathans rolled over these loans. However, it seems that these rollover decisions never expected to recover Nathans' money. For example:

> *It is interesting that the roll-over was being pressed by the lender [Nathans], in a situation where it knew that the borrower had not (and could not) pay the debt when due (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011para [311]).*

It is important to note that there is no evidence that Nathans ever rolled over loans to third parties, but only to VTL and related parties. The frequent rollovers affected the cash flows at Nathans as a significant part of its lending was bringing no repayments. To resolve the situation Nathans relied on retention of old investors and bringing in more investors. The following quote describes Nathans' approach to resolving this situation:

> *In the year to June 2006 Nathans received $4.9m of interest in cash yet paid out $9.1m in interest to secured debenture holders. The difference was met by funds received from subscriptions by new debenture holders (Field, 2011).*
>
> *Short said she was happy with the some 70 per cent [retention rate of investors], however the directors - Doolan, Moses and Young - wanted to achieve a 75 per cent retention target ("Witness outlines attempts to retain 75pc of Nathans investors," 2011).*

Since Nathans was lending long-term and borrowing short term, the above approach did not resolve the situation but rather postponed it. This was certainly not a good way to manage a finance company. However, Nathans appeared to have control over VTL related information. For example:

> *Mr Young had the opportunity to consider VTL documentation after joining that [VTL] board ……….. (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [408]).*

It has been disclosed previously that Nathans General manager had no access to VTL related financial information. According to the General Manager, *"he wasn't sure how the [VTL related] transactions were recorded on the companies' ledger"* (Mace, 2011c). It appears that the controlled flow of information resulted in almost no internal objections in terms of VTL related lending. However, findings indicate that there were concerns raised regarding Nathans' operations. For example:

> *[The Securities Commission raised concerns about Nathans, prospectus stating] In particular, it is not clear what proportion of Nathans' funds are loaned to VTL and other related parties (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011).*

The findings indicate that in response to the above concerns, when the Prospectus preparation team proposed to clearly disclose VTL related lending percentages in the prospectus, they met with resistance from the directors. For example: *"The responses from directors reflected a very real tension between full disclosure to the public and the commercial imperative of 'selling' the offer to the public" (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011Paras [172-174]).* Even though there was a difference of opinion regarding the changes required, the board allowed no conflict in that regard. The following quote from one of the director's email supports these findings.

> *David [Steytler] you keep quoting our external solicitor as the driving force behind this [suggestion to provide clear disclosure], who is the solicitor and when did a lawyer take control of the decisions the BOARD make? I AM NOT HAPPY WITH THE RISK SECTION, IT NEEDS MODIFICATION URGENTLY. David, do not copy management on your reply. Please only address the DIRECTORS (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011Para [181]).*

6.2.2 Dealing with Uncertainty and Risk (Uncertainty Avoidance)

Uncertainty and risk are important factors that affect decision making. According to Cyert and March (2001), organisations try to avoid situations requiring correct anticipation of future events (in terms of uncertainty and risk). For the purpose of this research, the focus was on the way the organisations dealt with the uncertainties and risk.

The concept of 'Uncertainty Avoidance' is represented by the keywords *Uncertainty, Risk, and Avoid*. For the keyword, Uncertainty*,* the *text search query in* NVivo-Enron generated 281 text references from 68 sources, whereas a total of 28 text references from 13 sources were generated in NVivo-Nathans. For the keyword, *Avoid,* NVivo Enron generated a total of 410 text references from 74 sources, whereas NVivo Nathans generated 17 text references from 9 sources. For the keyword, *Risk,* the queries used the concept 'Managing and controlling risk' for both the organisations. To avoid the repetition, no direct quotes for the keyword *Risk* are provided under this section, rather a reference is made to the previously cited quotes. The results of the queries are presented in Appendix B (Table B.9. 1, Table B.9. 2, Table B.10. 1, and Table B.10. 2).

In the case of Enron quotes containing the keywords *Precarious, Dubious,* and *Avoid* have provided important details about the concept. Whereas in the case of Nathans quotes containing the words *Precarious, Doubt and Avoid* have been found to be useful. It is important to note that the quotes containing words *Risk* and *Risks* have also provided useful information in regard to uncertainty and risk (as part of decision making).

Dealing with Uncertainty and Risk - Enron

It has already been discussed under the section 'Managing and Controlling Risk' that Enron used SPEs to mitigate the uncertainties related to its financial books. These SPEs were used to control the financial statements/information of the company. In doing so, the focus of Enron was not on finding a solution to deal with uncertainties and risks, rather it hid/disguised the information to escape from those uncertainties. SPEs offered a temporary relief to the company, which indicates that Enron's decisions had a short-run orientation. Enron used a series of SPEs to gain ongoing relief, which indicates that long-term impacts were not evaluated. The following quotes further confirm these findings:

> *Some of Enron's most abusive SPEs were created to avoid reporting mark-to-market losses (Cunningham & Harris, 2006).*

> *Enron had investments in companies (which were not SPEs) that it consolidated or reported on the equity method. When the investments began to show losses, they were transferred to SPEs so Enron would not reflect the losses. Enron did not consolidate or report the SPEs on the equity method, and thus avoided reporting the loss (Cunningham & Harris, 2006).*

> *In order to avoid reporting a loss of $500 million at year-end 2000, the Raptors were cross-collateralized against each other (in effect combining their assets) for forty-five days. This support arrangement used the assets in the Raptors that were still above water as collateral for those not faring as well (Markham, 2006, p. 80).*

> *SPEs sold Enron put options on several of its investments. These allowed Enron to avoid showing losses when the investments declined in value because the losses were offset by the put-option obligations of the SPEs. However, Enron provided almost all of the funds for the SPEs that, presumably, were available to pay Enron should the investments decline in value. Consequently, Enron's shareholders could not avoid absorbing losses on the investments, but Enron could avoid showing those losses (Benston & Hartgraves, 2002).*

> *LJM2 provided the outside equity designed to avoid consolidation of the Raptor SPEs (Powers et al., 2002).*

On a further note the adoption of the MM Model was another source of uncertainty and risk for the company. As discussed previously under 'Managing and Controlling Risk', the company based its MM Model on an over optimistic approach/valuation. Here as well, the focus was on the positive impact on the reported earnings, and the long-term implications were ignored. For example*: "Under mark-to market accounting, these gains had been booked as earnings thus, to avoid reporting possible losses"*

(Gillan & Martin, 2007). Similarly, the handling of the Valhalla scandal indicates that the company valued short-run implications above the long-run implications, as *"the company was able to avoid defaulting on its $4 billion in debt because of some fortuitous profit racked up by a small trading subsidiary in Valhalla"* (Pearlstein, 2006).

It has been previously discussed under 'Managing and Controlling Risk' that Enron exercised its power to influence the decisions of third parties such as banks and financial institutions. The following quote further confirms Enron's approach to controlling its environment to deal with uncertainties and risks:

> *……… once again, Enron aggressively lobbied to avoid FERC oversight of many of its operations (Gillan & Martin, 2007).*

Dealing with Uncertainty and Risk - Nathans

In the case of Nathans, it has been discussed earlier (under Managing and Controlling Risks) that VTL and related party lending was one of the major sources of uncertainty and risk for the company. Nathans was aware that it could have bring severe implications for it. However, the approach, adopted by Nathans indicates that it focused on immediate implications and the long-term impact was not considered. As discussed previously, Nathans rolled over VTL related loans which was a short-term solution and Nathans used a series of rollover transactions to hide its bad debts. This was a quite similar approach to Enron's SPEs in terms of decision orientation. Nathans also disguised its financial statements to mislead the investors about its weak lending concentration and, like Enron, avoided full disclosure to cater for the related uncertainties and risks. The following quote confirms this finding:

> *And, in spite of its precarious financial position, in the eight weeks before collapsing into receivership Nathan Finance sent two reassuring letters to investors and prospective investors, and pulled in an extra $6m (McManus, 2010).*
>
> *"no bad debts written off" statement was only technically correct, because the Nathans and parent company VTL directors did "everything in their power to avoid any of its debts being classified as impaired,.."("Nathans directors 'bedevilled by conflict'," 2011).*

The above quotes also indicate that by controlling the information (to external parties) Nathans tried to control its environment. Even after being aware of the concerns of the Securities Commission, Nathans did not evaluate the long-term implications. The following quote supports that at that time as well the focus was on immediate implications:

> *"I strongly urge that the RISK section is changed as if this is going to market NO cash will come in ……………………. this is simply not commercial" (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011).*

6.2.3 Searching for Solutions (Problemistic Search)

The search for solutions is an important part of organisational decision making. According to Cyert and March (2001) the search for a solution for a problem is directed and motivated by the problem itself, and the search continues up to the time a solution is found. The authors further state that the organisations look for solutions close to the problem and near the existing solution, and the search is biased due to prior experience and expectations (Cyert & March, 2001). The biased search is also supported by the concept of Attention-based view. For the purpose of this research, the focus was on the way solutions were found for the problems faced by the organisations.

In this research the keywords *Problem* and *Solution* represent the concept of *'Problemistic Search'.* For the keyword, Problem*,* the *text search query in* NVivo-Enron generated 1638 text references from 105 sources, whereas a total of 56 text references from 23 sources were generated in NVivo-Nathans. For the keyword, Solution*,* NVivo Enron generated a total of 2179 text references from 105 sources, whereas NVivo Nathans generated 113 text references from 40 sources. The results of the queries are presented in Appendix B (Table B.11. 1, Table B.11. 2, Table B.12. 1, and Table B.12. 2).

In case of Enron, the query related to the keyword *Problem* resulted in quotes containing 8 different words, whereas the query related to the keyword *Solution* generated quotes containing 19 different types of words. However, in the case of Enron quotes containing the keywords *Problem, Problems, Trouble, Troubles*, *Result, Results, Resulting, Resulted, Solution, and Solutions* have provided important insights into the concept.

The results indicate that in the case of Nathans the query related to the keyword *Problem* provided quotes containing 6 different words. The query related to the keyword *Solution* generated quotes containing 13 different types of words. However, the quotes containing the keywords *Problem, Problems, Result, Results, Resulted,* and *Answer* have provided important insights into the concept.

Searching for Solutions - Enron

It has been found that Enron used the SPEs as a solution for many of its problems. These SPEs were used to provide "almost instant results" (Behr & Witt, 2002b) for the problems faced by Enron such as financial losses and non-performing assets (Olin, 2005). However, the SPEs were a temporary fix

(Olin, 2005) and did not really address the problem. The search was biased and paid attention to the immediate issues faced by the company. For example:

> *[Enron was facing losses] However, coming clean would have devalued the company's stock ………. Further, the rating agencies, such as Moody's and S&P, wanted to see steady cash flow. Enron's solution was found in …. [SPEs where Enron] engineered an array of "structured financing" designed to show cash flow that was not "flowing", profits that had not been earned, and considerably less debt than was actually there (Downes & Russ, 2005).*

Enron appeared to be satisfied with these temporary solutions, as they had a positive impact on its reported earnings. Following is an example of the selective attention towards the reported earnings:

> *[With the use of SPE] Enron's share of JEDI's debt was kept off Enron's balance sheet while Enron recorded its share of JEDI's earnings as equity income (Healy & Palepu, 2003).*

It is worth noting that many of these solutions did not even follow accounting rules and regulations and mislead the investors and other external parties. The following quote supports these findings and depicts a ceremonial compliance:

> *One accounting irregularity that arose from the JEDI joint venture was that Enron incorrectly included in income from JEDI the appreciation in the value of Enron stock owned (Healy & Palepu, 2003).*
>
> *…….. but the transactions did not follow those rules. ……. [These transactions] allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged--that is, that a third party was obligated to pay Enron the amount of those losses---when in fact that third party was simply an entity in which only Enron had a substantial economic stake (Powers et al., 2002).*
>
> *It was a paper hedge designed to achieve favorable financial statement results, not a substantive hedge that was intended actually to transfer Enron's risk of loss to an unrelated party. (The Role of the Board of Directors in the Enron's Collapse, 2002).*

Some other solutions adopted by Enron also indicate that many of its other short run solutions affected the disclosure in its financial statements and *"disguise[d] its problems with financial alchemy"* ("The Fall of Enron," 2001). For example:

> *…. Enron was revising its financial statements every year, which made it impossible to compare the results of one year with another. Its 1991 balance sheet cited "Marketable securities" worth $23 million, down from $28 million in 1990; in 1992 that line disappeared, and a new one popped up--the puzzling "Assets from price risk management activities." (Mack, 2002).*
>
> *Enron also regularly changed how it reported results from its businesses, lumping some together one year and others the next. This made it impossible to discern whether a particular unit, such as the power business, was earning or losing money or whether its assets were growing or shrinking (Mack, 2002).*

Enron was selective/biased in its attention. It focused on short-run implications and failed to evaluate its options carefully. For example, one of the SPEs (Chewco) was formed in a limited time and was a "*rush job*". The reason was that it was almost the end of the financial year for Enron and it needed to manage its financial statements *(Barnes, Barnett, & Schmitt, 2002).* Some other solutions adopted by Enron also indicate a similar approach. For example, in the case of the Valhalla trading scam (Barnes et al., 2002), Enron failed to take strict action against the traders because the trading operations at Valhalla had had a positive effect on Enron's earnings. On a further note, Enron did not pay attention to the objections related to its short run approach. For example, in 2001 Enron used *"accounting and financing solutions"* to fix problems related to one of its SPEs, while overriding the advice of its auditors which stated that *"the solutions violated accounting rules"* and are a *"temporary fix"* (Behr & Witt, 2002a).

It is found that Enron used a spiral of such transactions over the time (Powers et al., 2002), and many of these transactions brought negative implications for Enron. However, if one SPE was in trouble, Enron either created another SPE or designed a financial transaction to either temporarily delay or disguise the situation. For example, when Enron's investments in Raptors began to decline, raising doubts about the hedging transactions, Enron restructured it through another financial transaction to cover up the situation (Cornford, 2004). *"But these restructuring efforts were short-term solutions to fundamentally flawed transactions"* (Munzig, 2003). Enron kept on using such temporary measures until the *"problems in the Raptor entities became insoluble. Ultimately, the SPEs were terminated in September 2001"* (Powers et al., 2002).

The findings further indicate that there was a sense of denial at Enron as far as the shortcomings/drawbacks related to its short-term solutions were concerned, which is a kind of biased/selective attention. For example many times Enron *"failed to respond to indications of potential problems related to the use of SPE transactions"* (Batson, 2003a). Even when external parties started questioning the SPEs, Enron's initial reaction was to deny all that. For example

> *…. Mr. Lay had been warned about the company's accounting problems at a time when he was assuring employees and investors that Enron's stock would rebound (Jr & Berenson, 2002).*

> *[Lay] continued to claim publicly that all was well with the company, even after he found out that Enron was in trouble (Ferrell & Ferrell, 2011).*

Searching for Solutions - Nathans

In the case of Nathans, the findings indicate that most of the problems faced by Nathans were related to its parent company VTL. The following quotes support these findings:

> *VTL was at the root of all the finance company's problems (Mace, 2011a).*

It has been previously discussed in Chapter 5 that VTL and its related party lending constituted a major part of Nathans's lending. Nathans continued to advance money to VTL and its related parties despite the serious financial issues ("Banking breach not disclosed," 2007) faced by VTL and its related parties. It has been discussed earlier that the volume of VTL related lending and the constant rollover of that lending severely affected the cash flows at Nathans.

The rollover of loans meant that no cash was coming in for Nathans in terms of repayments from VTL and related parties. Moreover, VTL related lending constituted a large portion of Nathans's lending portfolio. This way VTL related lending severely affected the cash flow at Nathans. In that situation, it was expected that Nathans would decrease its VTL related lending and declare bad debts if VTL or its related parties were unable to repay the loans.

> *Nathans should have treated both loans as being substantially impaired. No provision for bad debts was made in respect of either loan by Nathans in its financial statements …….. (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011para [35]).*

However, the solution adopted by Nathans was totally the opposite. Nathans was *"dependent on fresh investment funds to maintain liquidity"* (McManus, 2010). This was a temporary fix for the problem, as Nathans was paying more in terms of interest than it was receiving as interest. The following quote further supports these findings and demonstrates the selective/biased attention of the company:

> *"The result was that there was no cash flow to enable Nathans to pay its debenture investors interest or to repay principal, except from the cash it obtained from new investors providing fresh funds to Nathans" (Gregor, 2011d).*

Nathans continued to ignore these problems and continued advancing money to VTL and related parties. For example:

> *These acquisitions occurred at a time when it was clear that neither the IVL nor VTL debts to Nathans could be paid without VTL selling some or all of its American business units. They resulted in an outflow of cash from Nathans (to fund acquisitions) rather than an inflow from a divestment strategy (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011para [286]).*

In this way, Nathans helped VTL and related parties, but its own problem of cash flow and non-repayment of its dues was still there. As a finance company, Nathans was supposed to inform its investors about the situation. However, Nathans disguised its financial information and presented a misleading picture of it through ceremonial compliance. For instance:

> *The words used in the 14 May 2007 letter created an impression of a successful finance company that had never had any problems with impaired debt ….. (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011para [246]).*

> *…… what was said to Nathans' investors in offer documents and marketing letters was "completely divorced from what was actually happening" (Gregor, 2011d).*

The findings further indicate that Nathans did not see VTL and related party lending as a real problem, rather what was more concerning for the company was the public disclosure of that information. The following quote supports these findings:

> *Mr Moses replied: "I hope the wording can be modified further to convey a true and realistic view of the risks without sticking it too far up investors‟ noses". Mr Hotchin then replied: "The Risk section is a major concern, I*

> *agree with Roger this will create a big problem for capital raising going forward. We need to tone this down if possible." (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011para [22]).*

6.2.4 Learning (Organisational Learning)

According to Cyert and March (2001) organisations learn over time from their experiences, which feeds back into their decision-making process and related choices. According to the authors, this learning will affect their choices regarding "what to strive for". Over time the organisations also learn to pay attention to certain parts of their environment and ignore others. The decision choices also change with the learning, which is the outcome of success or failure of certain decisions (Cyert & March, 2001).

For the purpose of this research, the keyword *Learning* represents the concept of *'Organisational Learning'.* The text search query for the keyword *Learning* generated total 7841 text references from 115 sources whereas a total of 444 text references from 74 sources were generated in NVivo-Nathans. The results of the text search query are presented in Appendix B (Table B.13. 1, Table B.13. 1).

In case of Enron the query related to the keyword *Learning* resulted in quotes containing 94 different words. However, in the case of Enron quotes containing the words *Learn, Learning, Learned, Know, Knowledge,* and *Knowing* have provided important details about the learning of Enron.

In the case of Nathans, the text search query related to the keyword *Learning* provided quotes containing 44 different words. However, the quotes containing the keywords *Know, Knowledge, Take, Checks,* and *Taking* have provided important insights into the concept.

Learning - Enron

The findings provide evidence that Enron learned from its experience as far as its reliance on and use of SPEs is concerned. Enron used a series of SPEs, one after another. For example:

> *In 1999, Fastow constructed two partnerships called LJM Cayman and LJM2 ……….. They were followed by four more, known as the Raptors. "You do it once, it works, and you do it again," (Barnes et al., 2002).*

As discussed previously in Chapter 4, Enron actually misused these SPEs, and most of the SPE transactions were flawed. This raises the question, *"Why did not Enron learn from these shortcomings of its SPE transactions and amended/changed its decision?"* The findings indicate that Enron failed to pay attention to the red flags in that regard, which could have affected the learning. The following quotes support these findings:

> *…. it is clear that Lay and Skilling failed to respond to red flags that, had they inquired, would have led them to the knowledge that senior officers were misusing SPE transactions and disseminating materially misleading financial information (Batson, 2003a).*

> *And a close reading of the available records suggests that the directors ………. missed critical signs as they repeatedly approved deals that inflated the company's profit (Abelson, 2002).*

The findings indicate that it was not only because of the failure to notice red flags, the learning was interrupted, but at certain instances, despite being aware of the issue, the board failed to learn and respond. For example, when questions were raised about the compensation that Fastow earned through his stake in an SPE, "*Enron's directors agree to monitor Mr. Fastow's compensation"* , however the directors failed to follow up on that and "*did not learn until much later that Mr. Fastow made at least $30 million through the partnerships"* (Abelson, 2002). On a similar note when concerns were raised about Fastow's financial interests in the SPEs (as he was an employee of Enron and had a conflict of interest), he sold his share to one of his close friends (also an Enron employee) (*The Role of the Board of Directors in the Enron's Collapse*, 2002). However, the board did not inquire about the buyer. The following quote indicates the casual approach towards that.

> *….. Outside Director Herbert Winokur testified, when asked if he had been interested in learning the identity of the person who purchased Fastow's interest in LJM1 and LJM2: "[I]ts management's responsibility to tell me what I should know …….. I didn't inquire because I assumed somebody would tell me if I needed to know." (Batson, 2003a).*

On a further note that Enron did not want to change or alter its decisions, if they were bringing in a positive impact on its reported earnings. This indicates that the criteria for change/learning were the reported financial values. The following quotes support these findings:

> *………. many other documents demonstrate that the Board knowingly allowed Enron to use high risk accounting techniques, questionable valuation methodologies, and highly structured transactions to achieve favorable financial statement results (The Role of the Board of Directors in the Enron's Collapse, 2002)*

The Enron Board of Directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was, and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse (The Role of the Board of Directors in the Enron's Collapse, 2002).

Enron's multi-billion dollar, off-the-books activity was disclosed to the Enron Board and received Board approval as a explicit strategy to improve Enron's financial statements (The Role of the Board of Directors in the Enron's Collapse, 2002).

The above quotes also indicate that Enron was mainly focused on reported earnings, which further points that the company failed to correct/acknowledge its mistakes, and reinforced its wrong practices based on short term outcomes. For example, as discussed in Chapter 4, Enron initially did not take strict action against traders at Valhalla, because it needed those reported earnings. However, later that ended in huge losses for the company. Similarly, Enron was approving SPEs despite the flaws, as it needed those inflated earnings. However, it failed to learn that it would bring negative consequences eventually.

The available evidence suggests that Enron employees were not expected to resist the usual practices at Enron. Thereby they learned not to oppose the practices. The following quotes provide support for these findings.

There is little evidence, to date, that Enron's employees were able to offer significant resistance, least of all resistance that was effective (Tourish & Vatcha, 2005).

If any employee came forward with some negative feedback, he was either not given due attention or rather punished for that. The following quotes indicate such practices at Enron.

He telephoned Lay's secretary and asked for an appointment to talk about what was happening in the tax department and beyond. "Every damn year the stretch kept going up," Hermann would later explain. "It just kept getting bigger and bigger. That to me was evidence of the fact we don't know what we're doing here. It bothered me. I wanted to tell him what was happening." A week went by. Lay's secretary called Hermann back and said Mr. Lay was busy and would be unable to meet with him (Behr & Witt, 2002a).

Fastow was furious that Watkins had talked to Ken Lay. Upon learning that she had, he told Watkins' direct supervisor that he wanted Watkins "out of here tonight" and seized the laptop computer from her desk (Brickey, 2003).

There were different versions of learning at Enron. The employees at the front learned to reinforce their faulty practices, and the others learned not to object to those practices.

According to the findings, there was not a free flow of information at Enron, and sometimes distorted or modified information was provided to the employees. For example:

……… Kaminski discovered that Enron's finance department had deceived his research team about the deals. ……… Kaminski supervised a team of finance whizzes who calculated the likely future gains and losses in stock and commodities trading (Behr & Witt, 2002a).

Now Kaminski and two of his key associates discovered that they had been given incorrect and misleading data, which had distorted some of the team's earlier analyses of the Raptors deals. And they'd recently been asked to perform calculations on some LJM deals without being told their work related to LJM or the Raptors (Behr & Witt, 2002a).

As stated above, Enron failed to acknowledge its wrongdoings or its faulty practices. However, Enron employees did learn from these practices. They learned to fall in line with the prevalent practices and internal norms at Enron. In this way, the feedback system collapsed and learning was affected. The following quotes support these findings.

[The] employees soon learned, the only meaningful performance measure was the relentless pursuit of profit at any cost (Arnold & Lange, 2004)

Whilst information asymmetry grew, management appeared to escalate their risk taking efforts aware that this would enhance the perception of their performance with little chance of being exposed (Arnold & Lange, 2004).

The employee adds that anyone who questioned suspect deals quickly learned to accept assurances of outside lawyers and accountants. She says there was little scrutiny of whether the earnings were real or how they were booked. The more people pushed the envelope with aggressive accounting, *she says, the harder they would have to push the next year ("The Environment was ripe for abuse," 2002).*

As one knowledgeable Enron employee put it: "Good deal vs. bad deal? Didn't matter. If it had a positive net present value (NPV) it could get done. Sometimes positive NPV didn't even matter in the name of strategic significance." (Thomas, 2002).

Learning - Nathans

The findings provide evidence that similarly to Enron, Nathans also failed to correct/acknowledge its wrong practices. The available evidence indicates that Nathans's directors failed to take due care while taking important decisions (Mace, 2011a). As discussed previously, Nathans had financial issues due to its VTL related lending. However, the continued lending to VTL and its related parties indicate the failure to learn on part of Nathans. Instead, the company either did not disclose the related information or disguised it (Field, 2011). For example:

while the documents acknowledged a "significant proportion" of Nathans lending was to VTL, the impression given was that those loans were arm's-length transactions on normal commercial terms, usually for no more than (Ross, 2011).

Nathans failed to amend its VTL related lending practices, even though it was becoming a concern for Nathans. For example, in 2006 one of the VTL's franchise holders *"threatened to send his knowledge of both companies' bad debts to the auditor"* (Mace, 2011i). Even the Perpetual Trust had concerns regarding Nathans VTL related lending (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011para [382]). In the wake of these concerns Nathans should have amended its VTL related practices. However, the company failed to amend its practices. The evidence related to the issuance of Investment Prospectus indicates that the company ignored the known facts and tried to disguise the information. It is found that Nathans issued untrue statements to raise funds (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011).

Internally Nathans was aware of these concerns. For example in an email Moses expressed his concerns : *"We must take great care to ensure we cannot be accused of non-compliance"* (Gregor, 2011c). Similarly, the directors were aware of the deteriorating financial condition of VTL and its related parties. However, the focus was on keep the business going by injecting in more funds. For instance:

"I strongly urge that the RISK section is changed as if this is going to market NO cash will come in" (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011).

On a further note, evidence suggests that Nathans also did not allow resistance to its practices, and also kept control over the flow of information. This should have affected the learning of the company. The following quotes support these findings:

David, you keep quoting our external solicitor as the driving force behind this, who is the solicitor and when did a lawyer take control of decisions the BOARD makes? I AM NOT HAPPY WITH THE RISK SECTION, IT NEEDS MODIFICATION URGENTLY. David, do not copy management on your reply, please only address the DIRECTORS." (The Queen v J. Hotchin: Sentencing remarks of Lang J., 2011).

6.3 Value Orientation

The study aimed to look into the Value Orientation of the decision makers. The objective here was to understand the decision preferences of the decision makers. For this purpose, the study focused on the decision preferences of Lay (Enron) and Moses (Nathans). A Text Search Query was used to extract the data related to the two participants. However, in this case, the query was set to find exact matches only, and not the synonyms and stemmed words as was the case for previous queries. The Text Search Query for the keyword Lay provided 2304 text references from 91 sources and the query for Moses returned with 371 text references from 74 sources. In the case of Enron, further data was collected from books as well. In the case of books, the researcher followed the Index for the keyword Lay to extract further data. It is important to note that in the case of Nathans no published books were available.

To analyse the data the researcher bracketed all her prior understanding about values to allow the data to inform freely about the underlying values of the decision participants. After the preliminary analysis, a list of value preferences emerged. These values further revealed three different categories of orientation that included Individual Orientation, Group Orientation, and Functional Orientation. The following sections provide further details of the Value Orientation of the participants.

6.3.1 Individual Orientation

Individual orientation reflects the preferences of the participants in the context of their self-interest that affected their corporate decisions. The findings informed that the participants considered their self-interest a priority, which affected their corporate decisions. The following sections present the details of findings related to the individual orientation of both the participants.

Individual Orientation - Kenneth Lay (Enron)

When Lay got the top job at Enron, his wife expressed that *"It's fun to be the king"* (McLean & Elkind, 2004, p. 10). The findings indicate that Lay maintained an extravagant lifestyle at the cost of Enron. For example: "*Kenneth Lay had Enron pay $7.1 million for a penthouse apartment, which he and his wife converted into a Venetian palace with dark woods, deep velvets, period statuary, and a vaulted brick ceiling in the kitchen"* (Swartz & Watkins, 2003). The findings further reveal that Enron was Lay's *"American dream"* (Ahrens, 2006b) which provided him with a lavish lifestyle. For example, Lay stated *"I realized the American dream. I lived a very expensive lifestyle, the type of lifestyle that is very difficult to turn on and off like a spigot"* (Ahrens, 2006b). This indicates that Lay became used to that lifestyle and found it hard to live without it. The findings further reveal that many times Lay used Enron's resources for his personal use. For instance:

> *Not only did he [Lay] use the company's fleet of airplanes for his private use; so did his children. Enron employees called the planes the Lay family taxi, so frequently did family members use them ……. Another time an Enron jet was dispatched to Monaco to deliver Robyn's [Linda Lay's daughter] bed (McLean & Elkind, 2004, p. 90).*

Many members of Lay's family worked for Enron. For example: *"Ken and Linda Lay had five children ……... four of the five worked at either Enron or Azurix, a water company Enron started in 1998"* (McLean & Elkind, 2004, p. 90). The point here is not that his family also worked at Enron, but the way his family used Enron's resources for personal benefits. For example:

> *His top executives were also dismayed at the way he [Lay] and his family openly fed at the Enron trough. "If you're the CEO of a public company, it isn't yours," says a former executive (McLean & Elkind, 2004, p. 90).*

Lay also misused his authority at Enron for the benefits of his family. The findings provide that *"He always had Enron employees use his sister's travel agency. And not just …… [Enron employees]; the local Andersen office and Enron's outside attorneys, Vinson and Elkins, were pressured into using her agency as well. Trouble was that it provided neither low cost nor good service"* (Watkins & Pearce, 2003). The following quote indicates that Lay ignored Enron's interests for his or his family's interest.

> *In late 1994, lawsuits were filed alleging that Bruin's executive team, including Mark Lay [Lay's son], had embezzled more than $1 million…………*

while some of this was still going on, Enron decided to do a deal with another small company that Mark Lay had gotten involved with. Enron agreed to reimburse over $1 million of this company's expenses; as part of the deal Mark got three-year contract with Enron guaranteeing him almost $1 million in salary and bonuses, plus 20,000 Enron options (McLean & Elkind, 2004, p. 90).

The available evidence further indicates that Lay also exploited Enron's policies for his individual interest. For example, Enron provided Lay with a Line of Credit as part of his employment contract. The available evidence suggests that Lay exploited that facility. For example, *"The line of credit was originally set at $4 million and was later increased to $7.5 million. The aggregate amount withdrawn pursuant to this line of credit from 1997 through 2001 was over $106 million"* (Schmitt, 2003). The findings indicate that as far as the line of credit was concerned it was more than it appeared as the frequent use of the line of credit or the amount withdrawn through that line. It is worth noting that *"during 1997 through 2001, Mr. Lay repaid principal amounts of $99.3 million. Over $94 million of this amount was repaid with 2.1 million shares of Enron stock"* (Schmitt, 2003). However, *"Lay's repayment to Enron of more than $94 million of loans with Enron stock was not duly authorized or approved by the Enron Board under applicable corporate law"* (Batson, 2003a). In this way, Lay was *"effectively selling [Enron] stock back to Enron"* (Gillan & Martin, 2007), and that too without due approval. The above evidence, related to the use of a line of credit by Lay, indicates that he misused/exploited Enron's resources and bypassed established Enron procedures for his personal gain.

The findings further reveal that Lay's Individual Orientation guided his decisions not only during Enron's peak time but also at the time of its downfall. For example, the following quote indicates that Lay prioritised his personal needs while ignoring the interests of his staff and the financial difficulties faced by the company.

Lay chartered a boat ……………. for $200,000 for his wife's birthday. Another $12,000 was spent on Lay's birthday celebration. Another $20,000 on antiques on a trip to Spain. [However] Months later, Lay laid-off Enron employees and canceled the Enron Christmas party to cut company costs (Ahrens, 2006b).

When Enron was looking for a way to escape bankruptcy, Lay took care of his self-interest. For instance, "*Lay 'maxed out' his corporate* line of credit a day before Enron's ill-fated merger with rival Dynegy cratered" (Johnson, 2006a). And when he was questioned about that withdrawal, he justified his decision, which indicates that he was taking care of his gains/losses before that of Enron or its employees. The following quote supports these findings:

> *"You still took $1 million from Enron while its bankruptcy was being drafted," Hueston stated. "Yes," Lay said. "And you saw to it that you were taken care of before the employees were," Hueston said. Lay responded by saying there was very little the company could do for its employees in bankruptcy (Ahrens, 2006b).*

The findings suggest that Lay tried to rescue Enron from a bankruptcy. For example, despite knowing the bleak financial situation of Enron he tried to build confidence among Enron employees. He advised the employees to invest in Enron stock. He told the employees *"My personal belief is that Enron stock is an incredible bargain at current prices, and we will look back in a couple of years from now and see the great opportunity that we currently have"* (Behr & Witt, 2002a). However, Lay himself never wanted to take that risk, as he was either selling his Enron shares (Johnson, 2006a) or was repaying his credit line (Behr & Witt, 2002a) with those shares at that time.

Even when Enron was negotiating a merger with Dynegy to escape bankruptcy, Lay did keep his self-interest in mind. He was negotiating *"$60 million in severance pay upon consummation of the merger with Dynegy"* (Markham, 2006, p. 87).

Individual Orientation - Kenneth Roger Moses (Nathans)

It has been discussed earlier in Chapter 5, that Moses had an investment stake in VTL, and that most of Nathans's lending was to VTL and its related parties. In the previous sections (Corporate Governance Functions, and Decision Processes) it has been stated that VTL related lending caused most of the troubles for Nathans. As far as Moses's Individual Orientation is concerned, it appears that due to his financial interest in VTL, he failed to undertake corrective actions to safeguard the interest of Nathans. The following quote indicates that Moses joined Nathans and VTL so as to be part of a revolutionary vending machine business idea.

> *Moses said he joined Nathans and VTL on hearing about an idea, from Hotchin and Doolan, which was good enough to "revolutionise the vending machine industry " (Anderson, 2011b).*

However, the vending business belonged to VTL and not Nathans. This indicates that Moses's primary interest was in VTL and that he joined Nathans as it was the financial lifeline of VTL. The available evidence indicates that Moses represented VTL in its financial dealing with Nathans (Mace, 2011c). The findings suggest that Moses's personal interests in VTL affected his decisions at Nathans and that he gave VTL priority over Nathans. It is important to note that, according to Moses *“Banks don’t like start-up venture businesses”* (Bond, 2011a) and that it was hard to get external financing for VTL (Bond, 2011a; Vaughan, 2012). The following quote by Moses indicates that he knew the significance of the lending decisions/criteria of a finance company, but failed to adapt to that due to his personal interests in VTL.

> *Nick Leeson destroyed Baring Investment bank by accumulating bad investments, not by making the bad investments all at the same time (Moses, 1996).*

6.3.2 Group Orientation

Group orientation reflects the preferences of the participants in relation to the other members of the group including fellow directors/colleagues, and employees. The findings inform that group orientation affected the decisions. The following section present the details related to the group orientation of both the participants.

Group Orientation - Kenneth Lay (Enron)

The findings suggest that Lay preferred to have his close confidants around. For instance*, “After the merger of Inter North- HNG Lay had hired lots of his old cronies”* at Enron (McLean & Elkind, 2004, p. 25). This appeared to be Lay’s way of avoiding any kind of dissension. Lay believed that key to success is the people (Kaminski & Martin, 2001), and he believed in providing monetary benefits to his colleagues and staff to keep them motivated. Lay was the CEO and Chairman of Enron and was active in running the company; many of the policies at Enron reflect this kind of group orientation. The following quotes support these findings.

> *He [Lay] began lobbying for higher salaries for the board members [after the merger of HNG InterNorth] ….. (Swartz & Watkins, 2003, p. 29).*

> *Enron made donations to groups with which directors were affiliated …………… [Enron directors] received consulting fees from Enron …. (Gillan & Martin, 2007).*

> *Enron did not have a general policy or program relating to executive loans. However, from time to time Enron extended loans to various executives (Schmitt, 2003).*

The findings further reveal that mainly Lay and Skilling’s confidants enjoyed more rewards compared to other executives. For example:

> *There was always a huge salary, a bonus, stock options or stock, and perhaps even half-dozen parking spaces monitored by security cameras for the Romans within Enron who were tight with Lay or Skilling (Fusaro & Miller, 2002, p. 40).*

However, Lay preferred to have close relations with all of his employees to gain their loyalty (Mack, 1987). For example*, "Lay made a point of personally serving drinks to subordinates [at company functions] ……. he remembered names, listened earnestly, and seemed to care about what you thought"* (McLean & Elkind, 2004, p. 3). In this way, he won the trust of his employees and motivated them. For instance:

> *"You can imagine,' adds Jim Rogers, "how excited young people four or five levels down in the organization get when the chairman of the board calls to tell them, "You're doing great'' (Mack, 1987).*

Another important aspect of Lay's group orientation was that he gave executives freedom and authority to work. The following quote supports these findings.

> *"I'm more of a delegator," Lay testified. "I have a decentralized manager approach to business." ………. Lay testified that his management strategy was two-fold: hire the best talent he could find and then give them "room to run." (Ahrens, 2006a).*

The freedom and authority came with high expectations in terms of results. For example, Lay stated "*Individuals are empowered to do what they think is best ….. [however,] we insist on results"* (Fusaro & Miller, 2002, p. 47). Lay believed that by achieving expected results employees may *"be able to provide financially and otherwise for their families in a way that they'd never really dreamed of"* (Lay, 2004). This further confirms that Lay believed strongly in the power of monetary rewards. It is found Lay did not object even if the employees exceeded their authority or misused it, provided they delivered the expected results, as was the case of the Valhalla trading scam (discussed in detail in Chapter 4).

Group Orientation - Kenneth Roger Moses (Nathans)

In the case of Moses, the findings indicate that Moses was part of a group which included fellow directors at Nathans. The group had a common financial interest in VTL (as discussed in Chapter 5). It has been discussed in the earlier sections of this chapter that Nathans' interest was ignored to meet the financial needs of VTL. It seems that the common financial interest of the group overshadowed the decisions, as there is no evidence that Moses took any concrete steps to revive Nathans' situation. It has already been discussed in the previous sections that Nathans' directors gained access to VTL related documents only after they became the directors of VTL. This further confirms the presence of a group orientation.

On a further note (as discussed in Chapter 5) Moses never objected to the capitalisation of loans to the trusts associated with the other directors, and the lack of security. Nathans was receiving no repayments against these loans, as the interest was also capitalised. Moses firstly allowed the capitalisation for the trust related to Hotchin and later for the trust related to Doolan. It is important to note that Hotchin proposed to sell his VTL shares to repay Nathans. But one of the VTL's directors proposed capitalisation of the loan to Moses (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [36]). The failure of Moses to object to this capitalisation indicates group orientation, where the organisation's interest was ignored to take care of the interest of fellow directors.

The findings further confirm that group orientation affected Moses' decisions. For example, in regard to the investment statement, Moses "*responded by saying that he regarded the requirements for the Risk section as being tough but added that, presumably, there was no option but to comply for regulatory purposes".* But Hotchin said that the *"Risk|| section of the investment statement should be toned down".* And later on Moses agreed with Hotchin stating that "*We need to tread the fine line between being open and upfront, but not overly obvious"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [176, 178]). It is also worthy of note and has been discussed in the previous sections, that Nathans's executives were given restricted access to information. This further confirms that Nathans directors worked as a close confidant group.

6.3.3 Functional Orientation

Functional Orientation - Kenneth Lay (Enron)

The findings suggest that a functional orientation affected Lay's decisions. Lay's functional orientation seemed to focus on the short run and on immediate results while ignoring the long-term impacts. This orientation is well reflected in his various decisions such as the Valhalla trading scam, and the decisions related to the SPEs. For example, in the case of the Valhalla trading scam, as discussed in Chapter 4, Lay's was focused on short-term functionality/results for the organisation. He said, *"I've decided we're not going to discharge the people involved in this because the company needs those earnings"* (Barnes et al., 2002). Here Lay's functional orientation seems to be supported by his group orientation as the board did not oppose his decision to not to terminate the traders. For example:

> *"No one pounded the table and said these guys are crooks." (McLean & Elkind, 2004, p. 19).*

The findings indicate that *"Lay persuaded directors to keep things quiet, at least until the company could unwind some of its potentially devastating trading positions"* (Pearlstein, 2006). This indicates an orientation where the facts were denied to cover things up. On a further note, there were some executives whose concerns, regarding the Valhalla trading, were either not addressed or ignored. For instance

> *"What do I have to do to get you to understand that this could do devastating damage to our company?" Muckleroy asked Lay (McLean & Elkind, 2004, p. 22).*

> *"I was waiting for Lay to fire them on the spot," says one participant in a (Barnes et al., 2002).*

Since Lay's functional orientation was short run based, the problem at Valhalla returned and at that time Enron's financial condition did not allow a further cover up. Hence Lay was left with no choice but to take corrective measures and *Enron "reported $140 million pre-tax loss that wiped out about half of Enron's profit for the year"* (Pearlstein, 2006). This indicates a functional orientation where it was preferable to cover up or hide the issues threatening the reported financial results of the company.

It is important to note that Lay's short run focused functional orientation did not change after the Valhalla incident, where hiding the facts landed Enron in a big trouble. Rather, decisions were mainly taken based on the short-run impact. The decisions were not questioned or reconsidered if they were delivering good reported earnings. The following quotes support these findings:

> *"When the auditors told the board that Enron was following high-risk accounting, no one drilled deeper…" (Downes & Russ, 2005).*

> *"I realized that there was nobody doing any planning in that company," Hermann said. "They were just managing it day to day and trying to get earnings for the quarter" (Behr & Witt, 2002a).*

After the Valhalla scam, Lay continued to ignore the concerns raised by some of the executives. For example, in 2001 Enron's Chief of Staff wrote to Lay as follows:

> *"We should do the economically rational thing in every transaction and business and let the chips fall where they may. Instead of tying ourselves in a knot about managing earnings or write downs or avoiding an asset sale because it's on the books for more than the market, we should just make*

> *the rational economic decision ….. If we make the economically rational decisions over and over, the stock price will come along" (Batson, 2003a).*

However, no action was taken by Lay in this regard.

The findings related to the SPE transactions further confirm that decisions were taken on short run functionality. A decision option was preferred if it served the immediate needs of the company. For example, Lay's decision to grant Fastow an exemption from the Code of Ethics served the immediate need (for an investor in the SPEs) of the company, but created a conflict of interest *"thus allowing the CFO….. to profit from private partnerships he had set up"* to do business with Enron (Downes & Russ, 2005). Lay defended his decision stating that *"It isn't a conflict of interest. …….. Almost all big companies have related-party transactions"* (Smith & Emshwiller, 2003, p. 43). This conflict of interest later brought a significant negative impact to Enron (Batson, 2003a). The above findings are further confirmed by the fact that some of the SPE transactions were approved despite the evidence that *"Lay, Skilling, and the Outside Directors were in possession of facts necessary to conclude that the transactions lacked a rational business purpose before approving the transactions"* (Batson, 2003a). As discussed in Chapter 4, the SPEs were a crucial part of Enron's operations, yet Lay appeared to have a casual approach towards them, despite being aware of the related malpractices. This indicates that he was quite confident about the functionality of those SPEs. The following quote supports these findings:

> *Smith pressed for more detail ……….. "What was the name of the structured finance deal? Didn't it have a name?" ……………. "I'm not sure it had a name," Lay said. "It was an internal vehicle set up to finance certain assets". "What was it called?" Smith asked ……….. "It had to have a name if it was doing business with Enron. I mean, everything has a legal name or you can't do business with it, right?" Lay fumbled uncharacteristically for a moment, as if not quite sure what to say. Then he muffled the telephone mouthpiece and asked someone nearby, "What's the name of the thing?" When he came back on the line he said, again "I'm sorry, Rebecca, but I don't know if it had a name." (Smith & Emshwiller, 2003).*

The findings further indicate that Lay's functional orientation did not change despite the concrete grounds he had to believe that it would bring disastrous results for Enron. For example, when Lay received a memo from Watkins warning about the risky accounting practices, he did not intend to take a corrective action rather he tried to cover up the situation. The following quotes support these findings:

During Ms. Watkins' meeting with Ken Lay, he inquired whether she had talked to the SEC or the press. When she said she had not, he asked her to refrain from going public until he had time to investigate (Brickey, 2003).

Lay did admit, however, that when he ordered the investigation, he told James Derrick, Enron's general counsel, "let's not re-invent the wheel." (Ahrens, 2006a).

Lay ignored the suggestions of Watkins and seemed unhappy with her memo, which indicates that his primary concern was maintaining the reported earnings and the share prices of the company. His response towards Watkins' memo confirms his orientation.

Watkins had urged Lay not to hire Vinson & Elkins to investigate her concerns because its lawyers had worked on some of the very deals she challenged …. But Lay not only hired V&E, he authorized the firm to conduct a limited, preliminary inquiry…….. (Behr & Witt, 2002a).

The following action of Lay indicates that he rather wanted to get Watkins out of Enron, probably to stop further similar incidences.

Within days of meeting with Watkins, he contacted the organization's lawyers to inquire if grounds could be found for firing her (Tourish & Vatcha, 2005)

…. a telling e-mail from a Vinson & Elkins lawyer to Enron's Assistant General Counsel. Bearing the subject line "Confidential Employee Matter," [in the context of Watkins] who made the sensitive report……You . . . asked that I include in this communication a summary of the possible risks associated with discharging employees who report allegations of improper accounting practices……. Texas law does not currently protect corporate whistle-blowers……. there is the risk that the discharged employee will seek to convince some government oversight agency (e.g., IRS, SEC, etc.) that the corporation has engaged in materially misleading reporting or is otherwise non-compliant …….. (The message was dated just two days after Watkins met with Ken Lay.) (Brickey, 2003).

The above details related to the Valhalla scam and the SPEs indicate another aspect of Lay's orientation, which was breaking or changing the rules as and when needed to reach the targets. The following quotes confirms these findings:

Lay's contribution [in a book] was a chapter called "The New Energy Majors" in the "Innovation and Creativity" section. His major theme was "rule breakers get to the future first" (Swartz & Watkins, 2003, p. 118).

A regretful Kenneth L. Lay conceded he broke technical rules related to bank loans, but the former Enron Corp. chairman testified that the violations were an inadvertent result of his commitment to the energy company (Johnson, 2006b).

Functional Orientation - Kenneth Roger Moses (Nathans)

The findings indicate that functional orientation affected the decisions of Moses. It is important to note that *"most of the loan approval decisions in which directors participated were made by Mr Doolan and Mr Moses"* (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [135]). However Moses lacked clarity on the credit limits set in the Credit Policy of the company (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, paras [145, 146]). It has been discussed in the previous sections of this chapter and in Chapter 5, that Nathans mainly financed VTL and related operations. The credit policy of Nathans mainly had implications for VTL and related party lending, because Nathans did not advance money higher than the limits set in the policy to any other third party. This indicates a functional orientation where company's policies were not given significant weight in decision making. The following quotes further confirm these findings.

VTL and related party lending was not made at an arm's length, nor on a commercial basis, as it should have been ….. (Mace, 2011a).

[VTL and related party loan] requests were usually verbal and the approval process involved nothing more than an email to one of the directors. There would be no individual risk assessment of the loans or a revaluation of the assets [as should have been the case with Nathans's loan approval process] (Mace, 2011c).

……. "In the case of related party lending the approval process was often completely bypassed with lending exceeding permitted levels." (Mace, 2011h)

However, it is important to note that this type of functional orientation was present in the case of VTL and related party lending only and third party loans were sanctioned based on the established credit approval processes (*The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011).

Another aspect of Moses functional orientation was that decisions were not aimed at taking corrective action [for VTL and related issues] but to cover up or disguise the information. The following quotes support these findings.

> *……. in order to decrease the amount of intercompany debt VTL owed to Nathans Finance, several loans were made directly to VTL subsidiaries ……. (Mace, 2011d).*

> *"Nathans routinely rolled over impaired related party loans and capitalised the interest on them to create the guise of a performing asset in its financial statements."("Nathans directors 'bedevilled by conflict'," 2011).*

> *..... what was said to Nathans' investors in offer documents and marketing letters was "completely divorced from what was actually happening" (Gregor, 2011d).*

> *……. the company had made a small provision for bad debts, but did not acknowledge non-payment of many [intercompany] loans …… the classification of inter-company and master franchisee loans as current assets also painted a misleading picture …. (Mace, 2011j).*

> *[Despite the problems related to VTL and related party lending, Moses said] that Nathans had a positive story to tell and that the key message was that there were no bad debts and no problems of the type that had led to the collapse of three smaller finance companies, earlier in the year (The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J., 2011, para [168]).*

The findings suggest that by disguising the information Nathans was successful in collecting money through debentures. For instance, *"by August 2007, when Nathans was still taking in debenture funds, the company's position, particularly with regard to liquidity, was hopeless"* and the public was not aware of it (Field, 2011). This further indicates that Moses' functional orientation focused on short-run implications and ignored the long run impact. It is found that Moses was aware of the long-run implications and failed to address his own concerns about that. For example:

> *Moses then added he was worried and asked, in another email, "isn't it time we started to refocus our efforts toward the longer term" (Field, 2011).*

> *Mr Moses did nothing to ensure that this [reduction in VTL and related party lending] was achieved (Judgement of the Court: Between Mervyn Ian Doolan and The Queen and between Kenneth Roger Moses and The Queen, 2011).*

Another important aspect of his functional orientation was that he paid great importance to the compliance, but his focus was not on presenting a true and clear picture but on how to present the information to avoid any negative outcome. For example, Moses said in an email: *"We must take great care to ensure we cannot be accused of non-compliance. No matter how spurious the claim might be."* (Gregor, 2011c).

There are instances where Nathans's own rules were not followed while granting loans to VTL and related parties (*The Queen v J. Hotchin: Sentencing remarks of Lang J.*, 2011, para [29 b]; *The Queen v K. R. Moses, M. Doolan, D. M. Young: Reasons for Verdict of Heath J.*, 2011, para [148]).

Another aspect of the functional orientation of Moses was that the decisions were taken in the best interest of VTL and Nathans's interest was ignored (as discussed in the previous sections of this chapter and Chapter 5). Even after the bankruptcy incidence Moses firmly stressed that Nathans was doing well, for example:

> *But we had $16 million in the bank, we did not think we were under any cash flow pressure and we had certainly not missed any payments to investors or creditors (Vaughan, 2012).*

6.4 Chapter Summary

The aim of this chapter was to present the findings based on the analysis of the data. The findings in the context of the research questions and the relevant perspectives identified in earlier chapters are provided. The research used a start list for corporate governance functions and decision processes, but no start list was used to explore the perspective of value orientation. Appropriate coding frequency and details are provided where needed. In this way the findings are primarily presented in a qualitative way. Overall this thesis found links between poor corporate governance practices and corporate failures, and elaborated on the decision processes. The thesis also found three types of value orientation, including Individual, Group, and Functional, which affected the decisions of the decision makers.

The next chapter provides discussion and the conclusion of the thesis by relating these findings to the existing literature.

Chapter 7

Discussion

The purpose of this research is to explore and understand the role of the behavioural aspects of corporate governance decision-making in corporate failures, which was the research gap as found in Chapter 2. The study attempted to derive a theory, grounded in the decision-centred behavioural aspects of corporate governance, to explain the role of corporate governance in corporate failures. The research selected the case study as an appropriate approach to achieve this purpose and this is discussed in Chapter 3. Chapters 4 and 5 provided an in-depth narrative of the individual case studies and Chapter 6 presented a combined analysis of the findings.

This chapter uses 'Data-Theory Coupling' (Golden-Biddle & Locke, 2007, p. 52) to pursue the discussion and relate the findings of this research to existing literature. In doing so the chapter looks into the findings related to the role of corporate governance in corporate failures, with an extended focus on the similarities and deviations from the current literature. In this way, this study makes an important contribution to confirm and extend the existing literature. The discussion follows Patton (2015) in that *"qualitative interpretation begins with elucidating meanings",* thereby making sense of the available evidence/findings (Golden-Biddle & Locke, 2007; Patton, 2015). In this way, the research makes an important contribution, by addressing the issue *of "inadequate"* (Golden-Biddle & Locke, 2007) literature to explain the role of corporate governance in corporate failures. In particular, this research contributes by bringing the qualitative focus back into corporate governance research.

The first section of this chapter discusses the findings of the study with a focus on the primary contribution of the research towards a limited and inadequate understanding of the role of the behavioural aspects of corporate governance in corporate failures. The objective is to discuss how the findings of this study have advanced the present understanding of the role of corporate governance in corporate failures. The second section of this chapter presents the theoretical contribution of this research along with the limitations.

7.1 Discussion of the Essential Findings (Association Between the Behavioural Aspects of Corporate Governance Decision-making and Corporate Failure)

As discussed in Chapter 2, this research refers to Setting strategic direction, Formulating policy, Managing and controlling risk, Selecting CEO and Directors, and Monitoring performance as the main practices of corporate governance. These practices were the starting point of data analysis for this research. The study's findings suggest a relationship between the behavioural aspects of corporate governance and the corporate failure of both the organisations in the sample. Their corporate governance practices exhibit negative aspects that include flawed strategic orientation, myopic rational focus, cohesive and consistent long-term teams, internal information asymmetry, conflicts of interest, financial misrepresentation, subdued opposition, faulty monitoring systems, and an over-aggressive business approach. The following sub-sections provide details on how the findings of this research advance the academic understanding of various individual aspects related to the role of corporate governance in corporate failures. The overall contribution of these findings, and the resulting model is provided under Section 7.2.

7.1.1 Flawed Strategic Orientation

The findings of this research suggest that it was not strategies and policies in themselves, but the flawed strategic orientation through which those policies were implemented, that brought significant negative implications for both the organisations. Though some of Enron's strategies and policies had problems from the beginning, such as the inability or unwillingness to control the risks associated with the MM Model and the complex SPE transactions, it was primarily the strategic orientation behind the implementation of those strategies or policies that contributed to the failure. For instance, SPEs could have contributed towards Enron's growth and stability, had there been a genuine third party (instead of Enron-related party) investment. In that way Enron would have truly hedged its risks and would have sold its assets to actual third parties to book genuine returns. Similarly, in the case of Nathans, its policies provided for arm's length credit checks for all the lending including VTL related lending. However, the intention was merely to formally present policies that attracted investors and to satisfy third parties such as regulatory authorities. There was no genuine attempt to follow these policies in spirit or action.

Previous studies have highlighted the role of decision implementation in the success of decisions (Alexander, 1989; Bourgeois & Brodwin, 1984; Crawford, 2014; Elbanna, 2006; Hickson, Miller, & Wilson, 2003; Noble, 1999; Nutt, 1986). However, different researchers relate successful implementation to different factors. According to Quinn (1980) organizations need to create internal awareness, understanding and psychological commitment to successfully implement their decisions, while Nutt (1986) suggests applying intervention, persuasion, participation, and edict for a successful implementation. Bourgeois and Brodwin (1984) state that the shared perception of reality affects the implementation of decisions rather than the reality itself and Miller, Wilson, and Hickson (2004) consider managerial action and organizational context affect successful implementation. On the other hand, Amason (1996) relates successful implementation to the content of the decision, team consensus, and positive affective relationships.

The findings of this research further contribute to the existing body of literature, in terms of the role of the *"human element"* (Hickson et al., 2003) in the implementation of decisions. These findings extend the existing literature and provide evidence that strategic decisions may fail to deliver, despite good strategic content and clear *"performance expectations"* (Pinto & Prescott, 1990), due to the flawed strategic orientation/intention behind the implementation of those decisions. In this way the research findings relate to the gap (Noble, 1999) created by the *"overwhelming focus on the actual content of the strategic decisions"* as compared to the implementation (Alexander, 1989), and support the role of behavioural aspects (Noble, 1999) in successful strategic decisions.

7.1.2 Myopic Rational Focus

On taking the opinion of Doyle (1999) into consideration that rational decision-making is *"choosing among alternatives in a way that properly accords with the preferences and beliefs of an individual decision maker or those of a group making a joint decision"*, it seems that both the organisations were *"myopic rational"* (Carrillo & Gaduh, 2012) and focused on short-term or immediate outcomes while ignoring the long run consequences. For example, Enron provided a waiver to its own CFO to do business with it (by forming an SPE) and entered into complex hedging transactions with that SPE. This helped Enron to sort out its immediate concern of finding an investor to invest in its SPEs, but it also brought negative consequences (due to conflicts of interests) in the long run. Similarly, Nathans focused on short-term implications and ignored long-run consequences. For instance, to avoid the immediate concern of disclosure of bad debts in its financial statements, it rolled over VTL related loans and accepted VTL shares as security despite being aware of VTL's falling performance. In this way, it solved the immediate issue of a negative impact on financial statements but ignored the long-term impact on its financial sustainability.

These findings further extend our understanding of what Piezunka and Dahlander (2015) call the impact of "crowdsourcing": getting information from a large number of sources, some of which may fall beyond the boundaries of the organisation, but only attending to information from certain sources. This research supports that the decision makers have a tendency to rely on their close/trusted sources of information when it comes to attending to the information from a pool of sources (Piezunka & Dahlander, 2015). This could well be driven by the self-interest of the decision makers (Lee, Pitesa, Insead, & Pillutla, 2015). For example, at Enron the directors ignored the suggestions/warnings by the *Followers* or external sources such as print media. They relied on the feedback/suggestions of their close knitted group – the *Drivers.*

The issue of myopic focus has been well represented in the literature. Hambrick and Mason (1984) state that cognitive choices (myopic views) of decision makers have a huge impact on organizational outcomes, as decision information and context are filtered through these views. According to Larwood and Whittaker (1977), managerial myopia arises from the self-serving biases of the managers. In their seminal work, Levinthal and March (1993) state that the tendency to ignore the long run implications as well as the larger picture, and to overlook failures, can lead to a myopic focus. Levinthal and March (1993) further state that organizations often need to have a trade-off between short-run and long-run impacts, as both might not be in tune. This indicates that organizations need to strike a balance between short run and long run preferences. However, the findings reveal that both the organizations gave priority mainly to achieving short run considerations, and ignored the negative long-run consequences. Laverty (2004) considers organizational culture, process, and routines as the factors causing myopic rationality. The findings of this study further extend this understanding and reveal that myopic rationality leads to an organizational culture which in turn feeds back into myopic practice (details in Section 7.2).

7.1.3 Cohesive and Consistent Long-term Team

Both the organisations had a consistent long-term team (board), with hardly any changes in the committee memberships. According to Anderson, Melanson, and Maly (2007) directors with knowledge and experience pose more and better questions and engage in high-quality discussions, whereas the findings of this study reveal a lack of constructive questioning/criticism/discussion on the part of the qualified and experienced boards of both the organisations who mostly affirmed the proposed decisions. Westphal (1998) and Vafeas (2003) state that an increase in board independence leads to better corporate governance by increasing the monitoring capability of the board. However, this research lends support to Bhagat and Black (2002), and Kumar and Sivaramakrishnan (2008), and contributes evidence that board independence does not necessarily relate to better governance, and can lead to the failure of the organization. The role of cohesive and consistent long-term teams in the failure of an organization is presented in Section 7.2.

7.1.4 Internal Information Asymmetry

The findings of this study suggest internal information asymmetry in both the organizations, with controlled access to information. There was a deliberate intra-organizational restricted flow of information, with the internal transmission of manipulated or untrue information (Polman & Russo, 2012). In this way, both the organizations transmitted (Caldwell & O'Reilly, 1982) favourable information and restricted unfavourable information. This is in accord with Caldwell and O'Reilly (1982), Halperin and Clapp (2007, p. 260), and Polman and Russo (2012) that organisations may suffer from systematic information asymmetry as individuals may be selective in reporting only those factors that support their views or decisions. An example of this would be the systematic supply of manipulated information to RAC, at Enron, to gain their approval for certain transactions. And at Nathans, there was systematic control over VTL related information.

The concept of information asymmetry has been previously studied from quantitative and financial aspects (Biswas, Avittathur, & Chatterjee, 2016; Evans, Perrault, & Jones, 2017; Healy & Palepu, 2001). However this study brings forward the qualitative considerations of this aspect, and provides evidence that internal information asymmetry promotes an organisational culture that leads to failure. In this way, this research defends the existing literature that an information processing view is important in understanding the culture of the organization (Deshpande, Farley, & Webster, 1993).

According to Tong and Crosno (2016) information asymmetry can be useful in a business-to-business environment. However, this research has found evidence of only the negative impacts (organisational culture leading to failure) of information asymmetry. This difference could be due to one of the limitations of this study, as this research has abstained from looking into the positive aspects of corporate governance practices in the sample case organisations. The limitations of the study are discussed in detail in the following sections.

7.1.5 Conflicts of Interest

Both the organisations suffered from conflicts of interests. For instance, Enron's CFO had a personal interest in various SPEs, and Nathans' directors had a stake in VTL. According to Moore and Loewenstein (2004), and Demski (2003) conflicts of interest affect the decisions in an organisation and can lead to professional violations. Cain, Loewenstein, and Moore (2005) state that the conflicts of interest can negatively affect the decisions of the organisation, despite the due disclosure of those conflicts. In terms of this research, both the organisations were aware of the prevalent conflicts and formally addressed these issues. For example, Enron required its audit committee to monitor all the transactions with SPEs related to its CFO. Similarly, Nathans required stringent credit processes to approve VTL related debt (as was the case with third-party debt). However, that did not help in managing the conflicts. The findings of this research further extend the existing understanding, and suggest that even if the organisations formally address the conflicts of interest, they can still bring negative consequences. This is supported by Powers et al. (2002) in their report where they state that *"…. a conflict of this significance that could be managed only through so many controls and procedures should not have been approved in the first place."* The findings of this research are also significant in terms of depicting the role of conflicts of interests in promoting a culture leading to failure.

7.1.6 Financial Misrepresentation

Both the organisations engineered their financial statements and avoided significant disclosure in order to present a favourable picture to the internal and external parties. For example, Enron used SPEs' transactions to hide its debt and non-performing assets and to inflate its earnings, whereas Nathans rolled over non-performing debt to avoid recording of bad debts. Even though both the companies were facing serious issues such as liquidity and non-performing debt, the primary focus of both the organisations was on averting negative performance indicators rather than truly addressing the issues.

The concept of financial misrepresentation is widely addressed in the present literature. While Harris and Bromiley (2007), O'Connor, Priem, Coombs, and Gilley (2006), and Zhang, Bartol, Smith, Pfarrer, and Khanin (2008) recognise the negative implications of financial misrepresentation, Tucker and Zarowin (2006) consider managerial discretion on financial reporting advantageous in terms of providing information. Financial misrepresentation has been considered an illegal and criminal act (Baucus & Near, 1991; Mishina, Dykes, Block, & Pollock, 2010; O'Connor et al., 2006); however, Harris and Bromiley (2007) state that all financial misrepresentations do not necessarily lead to criminal convictions. This makes financial misrepresentation an appealing option for organisations. According to Clinard and Yeager (2011, p. 58), corporate culture is one of the primary factors that promotes financial misrepresentations and crime. The findings of this research further confirm the link between financial misrepresentations and corporate culture and further incorporate that a repeated and systematic pattern of financial misrepresentation leads to a corporate culture that results in corporate failure. In this way, the research findings indicate that financial misrepresentation is both the outcome and a factor of corporate culture. This further extends the existing literature which mainly links financial misrepresentation to financial implications such as stock prices, reported earnings, market response, and shareholder value (O'Connor et al., 2006; Tucker & Zarowin, 2006; Zhang et al., 2008); however this research adds value by demonstrating the qualitative implications of financial misrepresentation. The current research also indicates a negative relation between earnings management and strengthening of external rules and regulations (Sáenz González & García-Meca, 2014). However, the findings of this research provide that despite the strict and clear regulations, both the organisations indulged in earnings management. In these two organizations, rules provided insufficient controls on corporate conduct.

7.1.7 Subdued Opposition

The findings indicate that both the organisations subdued the opposition of their policies and practices either by force or by disseminating manipulated information. For example, there were concerns regarding Enron's policies both internally and externally. Enron employees showing concerns about or opposition to its policies and practices were either transferred or reprimanded to change their behaviour. Similarly, it used its market power and economic pressure to overcome the concerns raised by external parties. In the case of Nathans, it suppressed the concerns raised by VTL's franchise holders, and provided misleading information to external parties to subdue the opposition.

The literature considers conflict/opposition as an integral part of an organization. According to Pondy (1992) conflict is the very essence of an organization, whereas cooperation is an occasional event. On resolving the conflict Elías and Alkadry (2011) state that people are biased and take up information that aligns with their own thoughts and ideas, and that organizations, with deliberate efforts, can achieve integration of thoughts and have a constructive conflict. This demonstrates the positive impact of conflict, an opinion supported by Pondy (1992) but challenged by De Dreu (2008), who concludes that organisational conflict hinders the operations of the organization.

However, the findings of this research provide that rather than biased consideration of conflicting ideas, both the organisations subdued opposition and conflicting ideas by withholding true and fair information. In a way, the conflict resolution was achieved for the *"wrong reasons"* (Mitroff & Emshoff, 1979). It indicates that the two organisations did not have an *"active conflict"* (Pondy, 1992), the absence of which leads to subdued opposition. Pondy states that due to the absence of active conflict, one polar extreme becomes dominant and stops the flow of diverse ideas, which could eventually lead to failure. While Pondy considers that inactive conflict results in a lack of capacity to adapt which eventually leads to failure, this research suggests that subdued opposition/inactive conflict contributes toward the formation of an organizational culture that eventually leads to failure.

7.1.8 Faulty Monitoring System

The research findings of this study indicate the presence of a faulty monitoring system. For example, RAC at Enron was meant to assess and control the work of other departments. However, the performance review system of Enron required the other departments to evaluate the work of RAC, thereby creating a conflict of interest and thus affecting the monitoring setup. Similarly, at Nathans, the directors and staff working both for VTL and Nathans had the responsibility to evaluate and control the risks related to VTL related lending, which was also a faulty monitoring system. The findings of this research support that a faulty monitoring setup contributes towards a corporate culture that leads to failure.

7.1.9 Over-aggressive Business Approach

The corporate governance practices at both the organisations promoted over-aggressive business practices that pushed the limits of legality. Enron's recruitment strategy, performance review system, and compensation strategy reflected its promotion of risky and over-aggressive business practices. On a further note, the available evidence suggests the same for Nathans. For instance, Nathans's directors pushed limits to achieve a higher retention rate of investors, even though its retention rate was higher than the rest of the industry. This research demonstrates that over-aggressive practices promote an organizational culture that may contribute to failure.

As has been discussed earlier that the practices such as subduing opposition and controlled access to the information were used to suppress the negative or below par performance/outcome of the decisions of the *Drivers.* According to *Kuusela, Keil, and Maula (2017)* an organisation's response to the below par performance is based on how big the gap is. According to the authors, smaller gaps lead to resource-consuming acquisitions while larger gaps lead to divestment to free resources. However, the practices of both the organisations indicate that irrespective of the scale of the performance gap related to the decisions of the *Drivers*, there was an increase in commitment (similar to resource-consuming acquisition) of resources towards those decisions.

7.2 A Behavioural Model of the Role of Corporate Governance in Corporate Failure

This section presents the primary and significant contribution of this research: A behaviourally plausible decision centred model of the role of corporate governance in corporate failure (Figure 7.1).

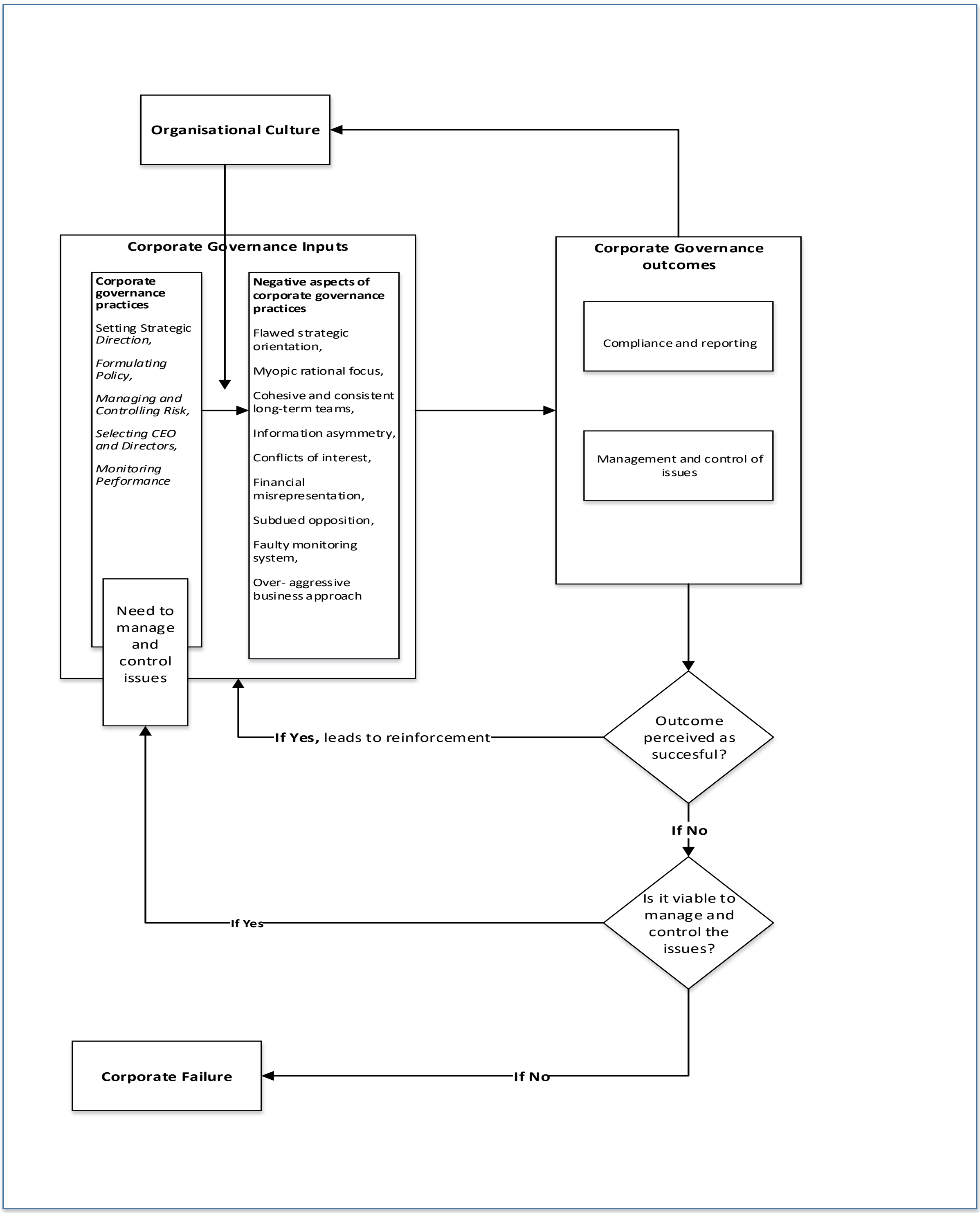

Figure 7.1 (A Behaviourally Plausible Decision Centred Model of the Role of Corporate Governance in Corporate Failure)

The model presents the way the negative aspects of corporate governance practices affect the corporate governance outcomes. These negative aspects not only affect the perceived success of the corporate governance outcomes, but also result in the formation of an organisation culture that leads to corporate failure. The individual role of each of the negative aspects has already been discussed and interpreted in the previous section. There are five major characteristics of this culture.

Firstly, it is not a single negative aspect but a group of negative aspects that form a culture bound to fail. *Secondly*, the resulting culture forms a loop with the corporate governance practices. In so saying, the resulting culture is a dynamic phenomenon that not only changes in response to the corporate governance practices but also affects those practices. *Thirdly,* this resulting culture is parallel to the formal/official shared values (Deshpande et al., 1993) of the organisations. For example, Enron's official shared values were Respect, Integrity, Communication and Excellence (Thomas, 2002), but the parallel culture did not reflect these.

*Fourthly, t*he parallel culture creates a divide in the organisations. The first group is termed the *Drivers,* who actively participate in the creation and promotion of this parallel culture. The other group consists of the *Followers*, who are inactive in terms of creating this parallel culture (the concept of *Drivers* and *Followers* is further interpreted in the following discussion). *Fifthly,* in order to create or impact the culture, the negative aspects persist over an extended period of time.

The perceived success of the corporate governance practices is another significant component of this explanation. The organisations carry on with their corporate governance practices (despite the negative aspects), until the outcome is perceived as successful by the *Drivers.* This effectively means that the perceived success of corporate governance practices leads to the persistent reinforcement of those practices over a period, which (as stated earlier) is an important factor in the development of the parallel culture. However, if the outcome is not perceived as successful by the *Drivers,* the organizations abandon the reinforcement of those practices and shift their focus to managing and controlling the issues related to that perceived failure. The notion of *perceived success* is subjective and depends on the perception of the *Drivers*. The concept of *perceived success* is what Kim and Rhee (2017) term as relative performance, is a behavioural consequence. Kim and Rhee relate this behavioural aspect to the position of the decision maker in the organisation structure, but, the findings of this study (as explained earlier) relate them to the concept of *Drivers* and *Followers.*

Once the issues are managed and/or controlled, the practice becomes part of the loop and eventually is incorporated into the culture and practices of the organization. However, if the organization fails to manage and/or control the issue, the process is repeated until the stage when it either achieves a resolution or finds it is not viable to manage and control the issues. The latter is an extreme event and leads to the failure/death of the organization.

7.2.1 The Drivers and the Followers

As stated earlier, this research makes an important contribution by introducing the concept of *Drivers* and *Followers,* and the role they play in the failure of an organization. The following (Table 7.1) highlights the major characteristics of both the groups.

Table 7.1 (The concept of Drivers and Followers)

	The Drivers	The Followers
Access to information	Full/Adequate	Limited/Inadequate
Conflicts of interests	Yes	No
Role in formation of organisational culture	Active	Inactive
Voicing of opinion	Possible	Not possible
Opinion	Valued	Not valued
Information asymmetry	Do not affect	Negatively affects
Remuneration system	Rewards	Do not reward

The *Followers* experience *"double bind"* (Argyris, 2000) where they understand that by complying with the organisation's official values they are defying the parallel culture prevalent in the organisation. This effectively means that whatever choice the *Followers* make it will be counterproductive in one way or another. As a result, most of the *Followers* prefer to adopt a *"culture of silence"* (Mugarura, 2016).

The *Drivers* display characteristics similar to *"narcissistic leaders"* (Maccoby, 2000), and are self-assured and pay selective and biased attention to the information. However, the *Drivers* operate as a group, which is in contrast to the nature of narcissistic leaders, who according to Maccoby (2000) keep others at arm's length with a strong wall of defence. However, in agreement with Maccoby (2000), when the *Drivers* face a threat, they act similarly to narcissistic leaders; they isolate themselves from the advice of others (the *Followers*) and act in defence. This is demonstrated by Lay's reaction to Watkins's memo, where instead of paying attention to the warning signals, he tried to find ways to expel Watkins from Enron. Similarly, when Nathans's external solicitor objected to the misrepresentation of information in its prospectus, Nathans's directors excluded him from the information loop. In this way, the *Drivers* stand by their own learning only and reinforce their learned past routines (Maccoby, 2000).

There exists a greater level of cohesiveness among the *Drivers*, despite the overall internal atmosphere of non-cohesiveness. On the other side the *Followers* self-censor (Leana, 1985) information due to the dominance and non-cooperation from the *Drivers*. In a way, the *Drivers* represent a highly cohesive group who use their collective rationalisations (Janis & Mann, 1977, p.

129) and power to support their shared beliefs and values. The high level of cohesion is one of the factors that lead to the absence of attention towards critical information and facts (Janis & Mann, 1977, p. 133). On a further note, Chatterjee and Pollock (2017) state that narcisstic leaders are interested in control rather than feedback, and in order to control a large organisation they rely on a loyal cadre of lieutenants. The distinction between the *Drivers* and *Followers* is in agreement with Katz (1982), who states that the long tenure of group members is positively linked to a reduction in communication and that members of a long-tenured group tend to ignore critical evaluation, information, and feedback from other sources (Katz, 1982). This effectively makes the *Drivers “unreceptive”* (Wiersema & Bantel, 1992) to the corrective strategic measures required.

7.2.2 A Behavioural Theory of the Firm (Extending the Current Understanding)

This section interprets and discusses the contribution made by this research towards the current understanding of *A Behavioral Theory of the Firm* by (Cyert & March, 2001).

Resolution of Conflict

This research supports the work of Cyert and March (2001) that most organisations exist and grow with considerable latent conflict of goals and have a quasi-resolution of conflict. According to the authors, even though organisations adopt certain procedures to resolve conflict, it does not reduce all goals to a common dimension, which means there is always a lack of internal consensus. The findings support that at both the organisations there was a lack of consensus. For example, the accounting and financial practices of Enron, and the content of the prospectus of Nathans always attracted internal concerns, which were never resolved.

Organisations deal with these conflicts by using local rationality which represents a tendency of the individuals or individual departments to focus on a limited set of problems and a limited set of goals. In this way, the organisations use delegation and specialisation to reduce a complex set of goals and problems to a number of sub-goals/problems. To achieve a fit between various sub decisions, the organisations adapt acceptable-level decision rules and they pay sequential attention to goals. The acceptable-level decision rules ensure that various local/sub decisions provide a joint solution to the problem. The organisations also attend to various problems and goals in sequence, by attending to one problem/goal at one time followed by another (Cyert & March, 2001).

The findings of this study support the view that organizational conflict has a quasi-resolution, and further contribute that the *Drivers* neither adapt acceptable-level decision rules nor do they pay sequential attention. Rather they rely on manipulation, suppression and control to achieve quasi-resolution of conflicts. *A Behavioral Theory of the Firm* by Cyert and March (2001) indicates a temporary compromise among different goals as the organisation attends to these different goals in sequence. However, according to this research, the goals/expectations of the *Followers* are permanently compromised. In doing so, the research supports that organisations pay different attention to different goals and solutions, an Attention-based view (Ocasio, 1997, 2011). Recent research on attention-based view relates the attention structure to the formal structure of the organisation (Gaba & Joseph, 2013; Joseph & Wilson, 2017), knowledge structure of the individuals, and the changes in the environment (Shepherd, McMullen, & Ocasio, 2017). The findings of this research, however, suggest that the attention structure of the organisation is related to the organisational culture driven by the *Drivers.* These findings are meaningful in explaining the divergent attention and perception of the decision makers regarding various goals and solutions.

According to Cyert and March (2001), organisations are able to overcome the inconsistencies related to the local rationality of various individuals/departments. However, this research demonstrates that the failed organisations did not overcome inconsistencies between the rationality of the *Drivers* and the *Followers*. In this way, the research supports the opinion of Kim and Rhee (2017) that the rational choice assumption is unrealistic.

Dealing with Uncertainty

Organisational decision making always entails dealing with uncertainty (Knight, 1921/2012). However, organisations avoid uncertainty during their decision-making, as they tend to avoid the requirement to correctly anticipate the distant future, hence the decisions are based on short-run feedback rather than long-run anticipation. In this way, the organisations solve pressing/immediate problems rather than developing long-run strategies (Cyert & March, 2001). The findings of this study support the work of Cyert and March as both the organisations focused on solving the pressing/immediate issues. The research findings further contribute to the concept of uncertainty avoidance by presenting that when a short run relief ceased to work or lost its effect, another short run measure was adopted to replace it and provide an ongoing relief.

Organisations arrange a negotiated environment to avoid anticipation of uncertainty related to the future reactions of other parts of their environment. The negotiated environment is achieved by imposing plans, standard operating procedures, industry traditions, and uncertainty in absorbing contracts on that environment. In this way, organisations achieve a manageable decision situation while avoiding planning that requires prediction of uncertain future events (Cyert & March, 2001). Similar views are expressed by Hofstede who states that uncertainty avoiding cultures persistently avoid ambiguity and look for structure in their organisation, institutions, and relationships, which makes events clearly interpretable and predictable (Hofstede, 2001, p. 148).

However, both Enron and Nathans avoided uncertainty by controlling their environment through measures such as market power, and manipulation and misrepresentation of the facts. The measures listed by Cyert and March (2001) basically focus on avoiding losses by negotiating a certain environment; however, the results of this study reveal that in the failed organisations the measures are adopted not to avoid losses but to avoid reporting of those losses.

Searching for Solutions

The findings of this research are consistent with those of Cyert and March (2001), that the organisation's search for a solution is stimulated by a problem and is directed towards finding a solution to that problem. This research supports the view that organisations do not undertake a regular planned search for changes in the current solutions, and search for options only when the current alternatives fail to match the expectations. This research further demonstrates that the failed organisations defined a problem in terms of its immediate impact and sought a solution to deal with that immediate impact. The long-term impact of the same problem remained to be dealt with later. However it was not part of sequential attention, rather the issues in waiting were addressed as and when they became immediate/pressing issues.

The organisations continue searching for a solution until a problem is solved. The solution is found either by discovering an alternative that achieves the goals or by revising the goals to match the available alternative (Cyert & March, 2001). However, according to this research the search continued until a solution was found as an immediate fix for an immediate issue. The immediate fixes were of a temporary nature, as they focused on short-term impacts only. A temporary fix was later replaced by another temporary fix.

As per Cyert and March (2001)the organisational search for a solution is biased due to the difference in training and experience of the decision makers. This research supports that the search for a solution is biased and further extends the understanding that the value orientation of the decision makers contributes towards that bias. The role of the value orientation is discussed in detail in the next section. Further according to Cyert and March, organisations adopt standard operating procedures and follow certain industry norms and practices during their decision-making. However, the findings of this study suggest that both the organisations disregarded many such practices, and sought a solution to disguise their problems rather than fixing them.

A recent review of literature on Problemistic search by Posen, Keil, Kim, and Meissner (2018) calls for "research to take a more process-oriented approach and to embody a more central role for cognition". This research has addressed this call and has explored the behavioural aspects of corporate decision making. The insights from this research provide cognitive and processual understanding of the organisational decision process (including Problemistic search). For example, as discussed earlier, the research informs about how an organisational culture lead by the *Drivers* result in divergent attention and perception regarding various goals and solutions.

Organisational Learning

Individual members are the agents of organisational learning. The learning of an organisation consists of the adaptation of goals, adaptation in attention rules, and adaptation in search rules. Adaptation of goals is influenced by the previous goals, previous experience with those goals, and the learning resulting from the experience of a similar organisation. Adaptation in attention rules refers to the selective attention paid to the environment, and that the learning of the organisations is reflected in the subjective attention rules which change in response to learning. The adaptation in search rules is the outcome of the success/failure of those rules (Cyert & March, 2001).

The literature relates the adaptation and learning of organisations to the reference groups (primarily to the economic reference groups/historic aspirations such as previous performance and the performance of the competitors) (Hu et al., 2017; Washburn & Bromiley, 2012). Kacperczyk et al. (2015) and (Washburn & Bromiley, 2012) call for more research to gain further insights into the social/peer reference groups, which according to Tarakci, Ateş, Floyd, Ahn, and Wooldridge (2018) are more important drivers of decision behaviour than the economic/historic reference points. Also Kuusela et al. (2017) for qualitative research to study the reference groups and related perspectives. This research has added to the existing understanding regarding reference groups by using a qualitative methodology to present the concepts of parallel culture and the *Drivers* and the *Followers*.

The findings of this study support that individual members of the organisation play an instrumental role in organisation learning. However, there are two parallel sets of learning. One set is for the *Drivers* and the other for the *Followers*. It is the learning of the *Drivers* that drives the adaptations in goals, attention rules and search rules. The learning of the *Drivers* also forms the culture of the organisation, while the learning of the *Followers* relates to their adaptation to the culture developed by the *Drivers*. Further, organisations do not seek active feedback from the *Followers.* Learning is the detection and correction of errors, and the lack of either or both inhibits learning (Argyris, 1976). Complete learning does not happen as the concerns of the *Followers* are not duly addressed by the organisations.

7.2.3 Value Orientation

This research makes an important contribution by introducing the types of value orientations that affect the decisions of the organizational leader of a failed organization. They include Individual, Social, and Functional orientations. The research findings support that the value orientation plays a critical role in the decision of the leaders of the failed organisations, as they screened the decision context and available information through these orientations.

The concept of individual orientation denotes a context where the leader considers self interest as the priority and takes the decision to serve this self-interest. The decisions dominated by individual orientation exploit organization resources and policies for individual interest. In decisions dominated by individual orientation, the decision maker considers organizational interest secondary to self-interest. The findings suggest that an individual orientation results in negative outcomes for corporate governance. An example of that would be that due to self-interest both the organisations allowed conflicts of interest to prevail at the cost of the organizational interest. The individual orientation of these leaders persisted during both good and bad phases (financial context) of the organization's life. The available evidence supports that, even near the end of the organisations, the leaders considered themselves a priority. For example, just before Enron's bankruptcy, Lay tried to secure a financial return for himself, while negotiating a possible merger with Dynegy.

The concept of social orientation denotes the value orientation of the leaders in the context of their group members. The findings of this research support that in terms of their social orientation, the leaders of the failed organisations preferred to have their close confidants around. The leader and his confidants worked as a closely knit group and supported the decisions of the leader and vice versa. In doing so the leader ignored any negative or opposing signs/information. For example, initially Moses had concerns regarding the information provided by Nathans in the investment statement. However, later on, he became convinced of the logic and went on to support his fellow directors, while ignoring the issues related to that statement. Similarly, Lay also supported his close aide Skilling, while ignoring the legal or ethical aspects. This kind of social orientation promotes unanimous decisions while avoiding dissension. However, the unanimity does not mean the actual absence of opposition, rather it is the suppression of opposition, where the *Followers* are subdued with various means such as information asymmetry.

The concept of functional orientation reflects on the day to day functional or operational preferences of the leader. The findings of this research suggest that the leaders of the failed organizations had short-term functional orientation where they focused on achieving immediate results while ignoring the long-term impacts. The functional orientation does not change or is not reconsidered until it fails to deliver the desired results. The findings further suggest that, with time, the leaders escalated their commitment towards their previous decisions or existing functional orientation. The failure of previous decisions or the challenges/opposition to the functional orientation of the leaders was positively related to the escalation of commitment.

The value orientation of these leaders was also reflected in the parallel culture in the organizations. For example the negative aspects of the conflicts of interest related to their individual orientation. Whereas, social orientation relates to information asymmetry and restricted access of information to the *Followers*. Similarly, as part of the social orientation, *Drivers* are generously rewarded and the *Followers* are reprimanded to fall in line. Further the negative aspect of financial misrepresentation reflected on the functional orientation of the leaders.

As stated in the literature review, there is need of further research to study the relation between the individual determinants of risk and the organisational determinants of risk (Kacperczyk et al., 2015). This research has made an important contribution by demonstrating the role of the Value Orientation of the individual decision makers in organisational decision making. The research has presented three types of Value Orientation that affected the decisions of the organisations. For example, it demonstrated how the Value Orientation of Lay and Moses have affected the decision making in their respective organisations.

7.3 Conclusion

7.3.1 Theoretical and Methodological Contributions

The objective of this research was not to replace the existing governance theories and related prescriptions with a direct alternative theory, but to refocus attention on underexplored aspects of corporate governance. It was highlighted in Chapter 2 that the research on corporate governance has seldom focused on the behavioural and human side of governance (Leblanc, 2004, 2013; Pugliese et al., 2009; Sonnenfeld, 2004), and that corporate governance is not a pure economic process and needs to be studied in the social context as well. Further, in this regard, the contemporary research on corporate governance has accommodated some issues such as board independence (Faleye, 2017; Hermalin & Weisbach, 1998, 2003; Mateescu, 2015; Sarkar, 2009), stock and equity ownership of directors (Rose, Mazza, Norman, & Rose, 2013); CEO Duality and board composition (António, Lúcia Lima, & Russell, 2017; Byrd, Fraser, Scott Lee, & Tartaroglu, 2012; Dalton, Dan, & Catherine, 2011), board accountability (Keay & Loughrey, 2015), and demographic characteristics (Huse, 2005). However, the behavioural and social components are still not duly addressed (Huse, 2005; Plessis, 2008). Thereby this research contributes towards enhancing the existing understanding of the behavioural aspects of corporate governance decision making. In so doing, the research has adapted a social context and a human context (Letza et al., 2008; Marnet, 2007) rather than a purely economic context. As a result, it establishes the human element as the most critical element of corporate governance - who is *"influenced by and is influencing"* (Senge, 1990, p. 78) the culture of the organisation.

Gavetti et al. (2007), believe that the legacy of *A Behavioral Theory of the Firm (*or The Carnegie school in general) has not been duly carried forward by contemporary researchers, who have drifted away from a decision making and organisational level of analysis. Retrospectively, Gavetti et al. (2007) call for a *"behaviorally plausible decision-centered perspective on organisations"*. This research attends to this call and presents *A behaviourally plausible decision-centred model of the role of corporate governance in corporate failure.* Further, this model also attempts to fill the research gap (in the context of the behavioural aspects of corporate governance) found in Chapter 2. Given that, this research introduces the concept of parallel culture as the key factor which emerges from corporate governance decisions and which also affects the future corporate governance decisions, ultimately leading to corporate failure. The research provide insights into the concept of corporate culture which according to Clark and Brown (2015); Minichilli et al. (2007) have significant impact on organisational decision making.

There has been an attempt by current researchers to investigate the behavioural aspects of corporate governance decision making. For instance Steckler and Clark (2018) have analysed the role of individual moral and virtue in corporate governance dynamics. Nakpodia and Adegbite (2018) have analysed the influence of three external groups (political, cultural, and religious) on the corporate governance practices of the organisations. Wu (2016) have provided a "behaviourally plausible decision-centred perspective" into the investment behaviour of venture capital firms. Kim and Rhee (2017) have integrated the behavioural perspective on decision making with the structural perspective. In response to the behaviourally plausible, decision-centred perspective, Wilson (2016) has provided a structure–feedback theory of decision making that integrates hierarchy and aspirations. With reference to the present research on behavioural aspects of decision making, this research makes a unique contribution as it provides insights into the impact of Value orientations of decision makers on organisational decision making. It also extends our understanding of behavioural aspects within the context of corporate culture.

The research also contributes to the further understanding of *A Behavioral Theory of the Firm,* by extending the existing understanding of the decision related concepts in relation to corporate failures. In this respect, the research relates the sub-processes of the above theory to behavioural aspects , which are not originally represented in the theory of Cyert and March (2001). The research also contributes by explaining the lack of early whistle-blowers in cases of corporate failures, by introducing and demonstrating the concept of *Drivers* and *Followers*.

According to Hiley and Smallman (1999), research on corporate failure is driven by quantitative methods such as regression analysis, multivariate discriminate analysis, and ratio analysis. An analysis of contemporary research confirms that this trend has continued over the years and quantitative research methods still dominate the research on corporate failure (Cielen, Peeters, & Vanhoof, 2004; Hsu & Wu, 2014; Lakshan & Wijekoon, 2012; Qaiser Rafique & Abdullah Al, 2015). Appiah, Chizema, and Arthur (2015) confirm this dominance and state that corporate failures are mainly analysed from quantitative and statistical perspectives and call for further research to address this methodological dominance. The research in the field of corporate governance has also used quantitative methods (Ees, Laan, & Postma, 2008; Erakoviç & Overall, 2010), whereas use of qualitative methods has been recommended by others (Roberts et al., 2005). This research makes this important methodological contribution by using and demonstrating the effectiveness of qualitative research methods (the suitability of which, for this specific topic, has been discussed in Chapter 3) to study issues related to corporate governance and corporate failures. On a further note Johnson (1992) has raised concerns that the strategic decisions have been analysed on the grounds of what should have been done, rather than observing the actual decision making. This research responds to this call by focusing on how the decisions are actually taken in the organisations. Further, as stated in the literature review, this research has also addressed the issue of ceremonial adoption (Bromley & Powell, 2012; Hambrick & Lovelace, 2018; Markóczy et al., 2013; Shi & Connelly, 2018) by drawing inferences from the outcomes (Shi & Connelly, 2018) of corporate governance decisions of the organisations.The research also contributes by driving three types of value orientation that affect the decisions of the decision maker. In doing so it has adopted a different approach from the previous value theories, such as (Rokeach, 1973) and (Schwartz, 2009), which were driven by a pre-set list of values and goals, and where respondents were asked to rank the given values in certain contexts. However, the value set provided by this research has emerged from the data itself, where no pre-set list was imposed. In this way the research makes an important contribution by exploring behaviour through actual choices/decisions rather than asking for an opinion on a pre-set list. This is a significant contribution in terms of focusing on individual orientation, which meets the call by Marnet (2007) to focus on individual levels of corporate governance decision making. Current research on values and organisational decision making are driven by quantitative or mixed method approaches (Pohling, Bzdok, Eigenstetter, Stumpf, & Strobel, 2016; Tang, 2016; Wisler, 2018). This research contributes by adopted and demonstrating qualitative research methods to study the concept of values.

7.3.2 Practical Implications

As has been discussed in Chapter 2, current actions and reactions (including legal and regulatory) to corporate failure have failed to address the problem and this research offers further insights in that regard. The research offers a clear perspective on the role of the behavioural aspects of corporate governance, which emphasizes the need to address these aspects in the form of internal and external policies. It is expected that the research findings will provide a more effective approach to legislation and policies, which as of now, focuses on the structural elements of governance (Levrau & Berghe, 2013), and has failed to check the reoccurring corporate failures (Marnet, 2007).

Even though minimal, the insights from this research regarding the whistle-blowers are valuable in terms of policy formulation for encouraging employees to speak up earlier.

Taking account of the human element in the complex dynamics of corporate governance is vital to a good corporate governance system (Huse, 2005). Thereby the findings of this research such as value orientations and the emergence of a parallel culture are expected to provide a vital understanding of good governance practices. These could be meaningful insights for designing legislative and regulatory improvements (which are at present insufficient to encourage ethical conduct (Plessis, 2008)), to improve corporate governance practices.

Further, this research is expected to help current boards and/or individual board members identify the behavioural indications that should trigger a watch out mode in terms of corporate governance practices. This is also expected to assist the outside third parties in identifying the warnings signs. However, as have been evident from the findings of this research, mere identification of the warning signs (faulty corporate governance practices) won't serve the purpose. It requires people from within and outside the organisation to take responsibility and actively respond to those signs. The board of directors might prefer to have truly independent knowledgeable observers (with no conflicts of interest at all) in the board, who provide independent reflections on the practices. However, again it comes back to the board members whether to attend to that feedback or not. Hence, it is suggested that the independent observer should have the independence to approach the regulatory authorities, should the board fails to act on the signs. Similarly, the whistle blowers from within the organisations need to be further protected. For instance, as provided in Appendix C, the complaint form of the Serious Fraud Office of New Zealand requires quite a bit of detail and related evidence to report the fraud to the office. Though the complaint can be made without the evidence, the office needs the evidence before it decides to the conduct the investigation (2018). It is understood that such type of investigation involves significant resources and related evidence needs to be evaluated prior to the investigation. However, this research has found that there was information asymmetry in the selected organisations and limited details were available to the *Followers.* This certainly affects the ability of the whistle blowers in terms of providing evidence. Therefore, this aspect requires reconsideration in terms of motivating the whistle blowers to come forward.

7.3.3 Limitations

The research findings are based on data from two case studies only. The nature of corporate governance is very complex and this research could have benefited from more cases. However, considering the availability of data and the time required in retrieving useful details (the study experienced data overload in the case of Enron and limited data in the case of Nathans, both of which were an issue), the study has made a significant contribution.

The second limitation comes from the nature of the data and data sources used for this study. The study used archived/secondary data. However, the triangulation of data was achieved through multiple data sources which added to the validity of the research findings. But this research to some extent still could not ignore the subjective interpretation of the original authors of those articles, books, reports etc. Moreover, the study adopted more of a social context, so thereby financial statements were beyond the scope of its research. However, specific financial details were analysed to understand the context of various decisions.

The research also abstained from looking into positive factors/aspects related to the governance practices of the selected case organisations. It is possible that an analysis of positive aspects could have provided meaningful comparative insights.

The research relied on coding by the researcher only, and no other coder was engaged to look for any disagreements. However, the research was substantially able to overcome this limitation with the Query feature of NVivo, the details of which have been provided in the previous chapters.

7.3.4 Future Research

This research contribution of this study is based on two case studies only. Further extension in this regard would add value to the results. Secondly, a further comparative research on successful corporate governance practices may add further value and strength to the behavioural aspects of corporate governance decision making.

While this research used data triangulation to achieve validity, future researchers would benefit from direct/live data in the form of meetings and interviews with the directors. However, that would be possible mainly for the study of successful/currently operating organisations only. Having said that, *"negotiating access to the black box"* of corporate governance is a difficult task, as participants are likely to be reluctant to share critical details (Leblanc, 2004). Moreover, the mere presence of an outsider (researcher) in the meetings can be obstructive , as participants may avoid discussing sensitive or inside matters in front of an outsider (Leblanc & Schwartz, 2007).

This research has addressed the concept of reference groups and their impact on the adaptation and learning of the individuals. The reference groups have two functions Normative (individuals seek to gain membership of a desirable group), and Comparative (individuals use the performance of a particular group as a benchmark). There is lack of research in terms of the Normative functions of the reference groups (Moliterno, Beck, Beckman, & Meyer, 2014). There is a future research opportunity to study the behaviour of new entrants from when they initially join the organisation to when they become part of a reference group (the *Drivers*/ the *Followers*).

As stated in the literature review, corporate governance deviance can happen in the form of underconforming or overconforming governance rules and practices. Aguilera et al. (2018). This research has primarily looked into the context of underconforming where the organisations fell short of the expected standard. However, overconforming to corporate governance practices is another possible area of research that could provide further insights into the process of corporate governance. For example in response to the principle of board independence, many organisations have removed all inside directors except the CEO (CEO-only boards). This offers the CEOs informational brokerage advantages as compared to the outside directors, which could negatively impact the corporate governance process in the organisations (Joseph, Ocasio, & McDonnell, 2014).

Finally this research has provided *A behaviourally plausible decision centred model of the role of corporate governance in corporate failure,* which offers a starting point for future research efforts. The research has brought behaviour back into corporate governance research, which calls for further research in this area. On a further note, future research may also provide useful insights by extending the focus to the exploration of implementing processes (Robert Baum & Wally, 2003).

Appendix A

Start List/Keywords

Table A. 1 (Corporate Governance - Keywords for Respective Functions)

Corporate Governance Function	Start list (Keywords for respective function)
Setting strategic direction	Strategy
Formulating policy	Policy
Managing and controlling risk	Risk
Selecting CEO and Directors	CEO, Director
Monitoring performance	Performance

Table A. 2 (Decision Process - Keywords for Respective Content)

Relational Concepts	Start list (Keywords for respective concept)
Quasi Resolution of Conflict	Conflict, Resolve
Uncertainty Avoidance	Uncertainty, Avoid
Problemistic Search	Problem, Solution
Organisational Learning	Learning

Appendix B

NVivo - Word Frequency Query

Following are the tables for NVivo - Word Frequency Query. The column 'Length' denominates the number of letters in the relevant word, whereas the column 'Count' refers to the frequency of the relevant word.

B.1 Word Frequency Query - Keyword: Strategy

Table B.1. 1 (Enron - Word Frequency - Keyword: Strategy)

Word	Length	Count	Weighted Percentage (%)
strategy	8	383	60.13
strategies	10	157	24.65
scheme	6	49	7.69
schemes	7	47	7.38
scheming	8	1	0.16

Table B.1. 2 (Nathans - Word Frequency - Keyword: Strategy)

Word	Length	Count	Weighted Percentage (%)
strategy	8	41	69.49
strategies	10	11	18.64
scheme	6	4	6.78
schemes	7	3	5.08

B.2 Word Frequency Query - Keyword: Policy

Table B.2. 1 (Enron - Word Frequency - Keyword: Policy)

Word	Length	Count	Weighted Percentage (%)
policy	6	394	44.77
insurance	9	229	26.02
policies	8	194	22.05
insured	7	14	1.59
insurer	7	13	1.48
insuring	8	12	1.36
insurers	8	11	1.25
insurance	5	5	0.57
insure	6	5	0.57
insurable	9	1	0.11
insurances	10	1	0.11
insures	7	1	0.11

Table B.2. 2 (Nathans - Word Frequency - Keyword: Policy)

Word	Length	Count	Weighted Percentage (%)
policy	6	39	46.99
policies	8	28	33.73
insurance	9	12	14.46
insurers	8	3	3.61
insurer	7	1	1.20

B.3 Word Frequency Query - Keyword: Risk

Table B.3. 1 (Enron - Word Frequency - Keyword: Risk)

Word	Length	Count	Weighted Percentage (%)
risk	4	1532	71.86
risks	5	361	16.93
chance	6	57	2.67
dangerous	9	28	1.31
danger	6	25	1.17
chances	7	21	0.98
hazard	6	17	0.80
gambling	8	12	0.56
risked	6	12	0.56
dangers	7	11	0.52
adventures	10	9	0.42
perils	6	9	0.42
gamble	6	7	0.33
hazards	7	7	0.33
perilous	8	4	0.19
risking	7	4	0.19
adventure	9	3	0.14
hazardous	9	3	0.14
dangerously	11	2	0.09
gambled	7	2	0.09
jeopardy	8	2	0.09
peril	5	2	0.09
adventurous	11	1	0.05
gambles	7	1	0.05

Table B.3. 2 (Nathans - Word Frequency - Keyword: Risk)

Word	Length	Count	Weighted Percentage (%)
risk	4	122	69.32
risks	5	43	24.43
chance	6	4	2.27
danger	6	4	2.27
dangerously	11	2	1.14
risked	6	1	0.57

B.4 Word Frequency Query - Keyword: CEO

Table B.4. 1 (Enron - Word Frequency - Keyword: CEO)

Word	Length	Count	Weighted Percentage (%)
Ceo	3	582	48.22
Ceos	4	79	6.55
chairman	8	11	0.91
Cfo	3	9	0.75
president	9	6	0.50
corporation	11	5	0.41

Table B.4. 2 (Nathans - Word Frequency - Keyword: CEO)

Word	Length	Count	Weighted Percentage (%)
chairman	8	74	81.32
ceo	3	6	6.59
chaired	7	3	3.30
chair	5	2	2.20
chairwoman	10	2	2.20
president	9	2	2.20
chairing	8	1	1.10
presided	8	1	1.10

B.5 Word Frequency Query - Keyword: Director

Table B.5. 1 (Enron - Word Frequency - Keyword: Director)

Word	Length	Count	Weighted Percentage (%)
management	10	2738	41.25
directors	9	1431	21.56
managers	8	769	11.58
director	8	745	11.22
manager	7	334	5.03
manage	6	230	3.46
managing	8	194	2.92
managed	7	128	1.93
manages	7	43	0.65
manageable	10	7	0.11
managements	11	6	0.09
conductor	9	5	0.08
Managers	5	4	0.06
directorates	12	2	0.03
conductors	10	1	0.02
directorate	11	1	0.02

Table B.5. 2 (Nathans - Word Frequency - Keyword: Director)

Word	Length	Count	Weighted Percentage (%)
directors	9	766	54.33
director	8	299	21.21
management	10	215	15.25
manager	7	52	3.69
managed	7	33	2.34
managing	8	19	1.35
manage	6	17	1.21
managers	8	4	0.28
manages	7	4	0.28
directorate	11	1	0.07

B.6 Word Frequency Query - Keyword: Performance

Table B.6. 1 (Enron - Word Frequency - Keyword: Performance)

Word	Length	Count	Weighted Percentage (%)
executive	9	1051	16.30
act	3	854	13.24
performance	11	825	12.79
executives	10	732	11.35
operations	10	487	7.55
operating	9	434	6.73
operate	7	196	3.04
perform	7	195	3.02
operation	9	189	2.93
acting	6	164	2.54
function	8	151	2.34
play	4	118	1.83
acts	4	113	1.75
played	6	94	1.46
performing	10	83	1.29
performed	9	75	1.16
functions	9	67	1.04
functioning	11	60	0.93
acted	5	58	0.90
execution	9	49	0.76
operational	11	49	0.76
operates	8	48	0.74
operated	8	45	0.70
executed	8	43	0.67
execute	7	41	0.64
functional	10	38	0.59
operator	8	26	0.40
plays	5	26	0.40
playing	7	25	0.39
executing	9	16	0.25
functioned	10	13	0.20
functionings	12	10	0.16
operation	4	10	0.16
operative	9	10	0.16
performs	8	10	0.16
performers	10	8	0.12
operators	9	6	0.09
functionalism	13	5	0.08
performer	9	5	0.08
functionality	13	4	0.06
performances	12	4	0.06
Execut??	6	2	0.03
functionally	12	2	0.03
playful	7	2	0.03
executes	8	1	0.02
functionalities	15	1	0.02
operant	7	1	0.02
operationally	13	1	0.02
performativity	14	1	0.02

Table B.6. 2 (Nathans - Word Frequency Query - Keyword: Performance)

Word	Length	Count	Weighted Percentage (%)
act	3	261	37.83
executive	9	62	8.99
operating	9	49	7.10
operations	10	47	6.81
performance	11	36	5.22
operated	8	29	4.20
functions	9	24	3.48
acted	5	22	3.19
operators	9	21	3.04
acting	6	20	2.90
operate	7	19	2.75
operation	9	17	2.46
operator	8	13	1.88
executives	10	12	1.74
performing	10	8	1.16
played	6	8	1.16
operational	11	6	0.87
performed	9	6	0.87
play	4	5	0.72
acts	4	4	0.58
operates	8	4	0.58
perform	7	3	0.43
playing	7	3	0.43
executed	8	2	0.29
execution	9	2	0.29
function	8	2	0.29
performs	8	2	0.29
functioning	11	1	0.14
operationally	13	1	0.14
performances	12	1	0.14

B.7 Word Frequency Query - Keyword: Conflict

Table B.7. 1 (Enron - Word Frequency - Keyword: Conflict)

Word	Length	Count	Weighted Percentage (%)
different	9	534	22.44
conflict	8	265	11.13
conflicts	9	263	11.05
engage	6	216	9.08
engaged	7	199	8.36
differences	11	171	7.18
difference	10	151	6.34
engagement	10	64	2.69
engaging	8	57	2.39
differ	6	54	2.27
fight	5	45	1.89
differently	11	41	1.72
conflicting	11	40	1.68
struggle	8	31	1.30
fighting	8	29	1.22
battle	6	27	1.13
engages	7	22	0.92
differing	9	19	0.80
dispute	7	17	0.71
struggled	9	17	0.71
contradictory	13	16	0.67
struggles	9	13	0.55
conflicted	10	12	0.50
infringement	12	12	0.50
disputed	8	10	0.42
disputes	8	10	0.42
struggling	10	10	0.42
differs	7	7	0.29
battles	7	6	0.25
engagements	11	6	0.25
fights	6	6	0.25
differed	8	5	0.21
contravened	11	2	0.08
battling	8	1	0.04
disputing	9	1	0.04
infringe	8	1	0.04

Table B.7. 2 (Nathans - Word Frequency - Keyword: Conflict)

Word	Length	Count	Weighted Percentage (%)
different	9	28	20.90
difference	10	19	14.18
conflict	8	12	8.96
differently	11	8	5.97
dispute	7	7	5.22
engage	6	7	5.22
conflicts	9	6	4.48
engaged	7	5	3.73
struggling	10	5	3.73
differences	11	4	2.99
engagement	10	4	2.99
differing	9	3	2.24
disputes	8	3	2.24
contradictory	13	2	1.49
contravene	10	2	1.49
contravened	11	2	1.49
differ	6	2	1.49
differed	8	2	1.49
engaging	8	2	1.49
struggle	8	2	1.49
battle	6	1	0.75
battles	7	1	0.75
conflicting	11	1	0.75
contravening	12	1	0.75
differs	7	1	0.75
disputed	8	1	0.75
engages	7	1	0.75
fight	5	1	0.75
fighting	8	1	0.75

B.8 Word Frequency Query - Keyword: Resolve

Table B.8. 1 (Enron - Word Frequency - Keyword: Resolve)

Word	Length	Count	Weighted Percentage (%)
purpose	7	445	23.25
purposes	8	188	9.82
concluded	9	166	8.67
decided	7	114	5.96
resolved	8	98	5.12
conclude	8	95	4.96
settle	6	92	4.81
answer	6	77	4.02
resolution	10	69	3.61
settled	7	53	2.77
solve	5	46	2.40
decide	6	45	2.35
resolutions	11	44	2.30
solving	7	39	2.04
concludes	9	38	1.99
resolve	7	38	1.99
answers	7	32	1.67
declared	8	28	1.46
deciding	8	24	1.25
concluding	10	19	0.99
firmly	6	17	0.89
solved	6	14	0.73
resolving	9	11	0.57
answering	9	10	0.52
purposeful	10	10	0.52
purposefully	12	10	0.52
settles	7	10	0.52
declaration	11	9	0.47
declare	7	9	0.47
answered	8	8	0.42
declaring	9	7	0.37
decides	7	6	0.31
dissolve	8	6	0.31
purposely	9	6	0.31
answerable	10	5	0.26
dissolved	9	5	0.26
solvent	7	5	0.26
decidedly	9	2	0.10
declares	8	2	0.10
resolves	8	2	0.10
settling	8	2	0.10
solvable	8	2	0.10
declarations	12	1	0.05
declarative	11	1	0.05
dissolves	9	1	0.05
firmness	8	1	0.05
solelv	4	1	0.05
solves	6	1	0.05

Table B.8. 2 (Nathans - Word Frequency - Keyword: Resolve)

Word	Length	Count	Weighted Percentage (%)
purpose	7	41	20.60
purposes	8	36	18.09
decided	7	20	10.05
concluded	9	16	8.04
deciding	8	9	4.52
answered	8	7	3.52
settled	7	7	3.52
answer	6	6	3.02
resolved	8	6	3.02
declared	8	5	2.51
solvent	7	5	2.51
decide	6	4	2.01
declaration	11	4	2.01
answers	7	3	1.51
conclude	8	3	1.51
concluding	10	3	1.51
solve	5	3	1.51
answering	9	2	1.01
declarations	12	2	1.01
declare	7	2	1.01
declaring	9	2	1.01
firmly	6	2	1.01
firms	5	2	1.01
resolution	10	2	1.01
resolve	7	2	1.01
adjudication	12	1	0.50
concludes	9	1	0.50
decidedly	9	1	0.50
resolving	9	1	0.50
settle	6	1	0.50

B.9 Word Frequency Query - Keyword: Uncertainty

Table B.9. 1 (Enron - Word Frequency - Keyword: Uncertainty)

Word	Length	Count	Weighted Percentage (%)
uncertainty	11	108	38.43
doubt	5	69	24.56
uncertain	9	40	14.23
dubious	7	17	6.05
uncertainties	13	16	5.69
doubtful	8	11	3.91
doubts	6	9	3.20
precarious	10	6	2.14
doubted	7	2	0.71
precariousness	14	2	0.71
doubtfully	10	1	0.36

Table B.9. 2 (Nathans - Word Frequency - Keyword: Uncertainty)

Word	Length	Count	Weighted Percentage (%)
doubt	5	17	60.71
doubtful	8	6	21.43
uncertain	9	2	7.14
doubts	6	1	3.57
precarious	10	1	3.57
uncertainties	13	1	3.57

B.10 Word Frequency Query - Keyword: Avoid

Table B.10. 1 (Enron - Word Frequency - Keyword: Avoid)

Word	Length	Count	Weighted Percentage (%)
avoid	5	255	62.20
avoidance	9	37	9.02
avoided	7	33	8.05
avoiding	8	29	7.07
void	4	7	1.71
avoids	6	6	1.46
avert	5	5	1.22
deflected	9	4	0.98
nullify	7	4	0.98
avoidable	9	3	0.73
deflect	7	3	0.73
dodge	5	3	0.73
averted	7	2	0.49
avoidant	8	2	0.49
dodged	6	2	0.49
nullified	9	2	0.49
shunned	7	2	0.49
avoider	7	1	0.24
deflecting	10	1	0.24
deflects	8	1	0.24
dodging	7	1	0.24
invalid	7	1	0.24
invalidated	11	1	0.24
invalidation	12	1	0.24
quash	5	1	0.24
shun	4	1	0.24
shunning	8	1	0.24
voids	5	1	0.24

Table B.10. 2 (Nathans - Word Frequency - Keyword: Avoid)

Word	Length	Count	Weighted Percentage (%)
avoid	5	7	41.18
avoided	7	4	23.53
avoids	6	3	17.65
avoiding	8	1	5.88
obviate	7	1	5.88
voiding	7	1	5.88

B.11 Word Frequency Query - Keyword: Problem

Table B.11. 1 (Enron - Word Frequency - Keyword: Problem)

Word	Length	Count	Weighted Percentage (%)
problems	8	581	35.47
problem	7	502	30.65
job	3	302	18.44
jobs	4	89	5.43
trouble	7	82	5.01
troubled	8	47	2.87
troubling	9	18	1.10
troubles	8	17	1.04

Table B.11. 2 (Nathans - Word Frequency - Keyword: Problem)

Word	Length	Count	Weighted Percentage (%)
problems	8	20	35.71
problem	7	16	28.57
troubled	8	10	17.86
trouble	7	7	12.50
job	3	2	3.57
troubles	8	1	1.79

B.12 Word Frequency Query - Keyword: Solution

Table B.12. 1 (Enron - Word Frequency - Keyword: Solution)

Word	Length	Count	Weighted Percentage (%)
result	6	712	32.68
results	7	593	27.21
resulting	9	164	7.53
resulted	8	154	7.07
solutions	9	123	5.64
solution	8	89	4.08
answer	6	77	3.53
resolution	10	69	3.17
resolutions	11	44	2.02
roots	5	40	1.84
answers	7	32	1.47
root	4	20	0.92
resultant	9	16	0.73
rooted	6	16	0.73
answering	9	10	0.46
answered	8	8	0.37
answerable	10	5	0.23
solvent	7	5	0.23
rooting	7	2	0.09

Table B.12. 2 (Nathans - Word Frequency - Keyword: Solution)

Word	Length	Count	Weighted Percentage (%)
result	6	54	47.79
results	7	16	14.16
resulted	8	10	8.85
answered	8	7	6.19
answer	6	6	5.31
solvent	7	5	4.42
resulting	9	4	3.54
answers	7	3	2.65
answering	9	2	1.77
resolution	10	2	1.77
solutions	9	2	1.77
root	4	1	0.88
solution	8	1	0.88

B.13 Word Frequency Query - Keyword: Learning

Table B.13. 1 (Enron - Word Frequency - Keyword: Learning)

Word	Length	Count	Weighted Percentage (%)
See	3	1322	16.86
Study	5	775	9.88
Take	4	542	6.91
learning	8	475	6.06
Know	4	365	4.66
knowledge	9	357	4.55
studies	7	349	4.45
Letter	6	284	3.62
Taking	6	267	3.41
conditions	10	212	2.70
hearing	7	197	2.51
determine	9	170	2.17
determined	10	169	2.16
condition	9	158	2.02
Con	3	155	1.98
learned	7	126	1.61
Learn	5	122	1.56
acquired	8	114	1.45
takes	5	114	1.45
acquisition	11	107	1.36
studied	7	91	1.16
knowing	7	85	1.08
read	4	83	1.06
acquisitions	12	80	1.02
discovered	10	61	0.78
hearings	8	56	0.71
reading	7	54	0.69
acquire	7	49	0.62
knows	5	49	0.62
checks	6	48	0.61
letters	7	48	0.61
determination	13	46	0.59
seeing	6	44	0.56
check	5	41	0.52
determining	11	37	0.47
discovering	11	37	0.47
watch	5	33	0.42
acquiring	9	30	0.38
determinants	12	30	0.38
teaching	8	29	0.37
hear	4	28	0.36
studying	8	28	0.36
determines	10	26	0.33
knowingly	9	25	0.32
discover	8	23	0.29
scholarship	11	23	0.29
sees	4	23	0.29
instructions	12	19	0.24
instructed	10	17	0.22

instruction	11	16	0.20
teach	5	12	0.15
ascertain	9	11	0.14
knowledgeable	13	11	0.14
learns	6	11	0.14
watched	7	11	0.14
determinant	11	10	0.13
conditional	11	9	0.11
teaches	7	9	0.11
watching	8	9	0.11
checking	8	8	0.10
acquires	8	7	0.09
cons	4	7	0.09
acquirer	8	6	0.08
checked	7	6	0.08
determinations	14	6	0.08
conditioning	12	5	0.06
instructive	11	5	0.06
reads	5	5	0.06
conditioned	11	4	0.05
determinable	12	4	0.05
determinism	11	4	0.05
scholarships	12	4	0.05
hears	5	3	0.04
instructional	13	3	0.04
readings	8	3	0.04
teachings	9	3	0.04
acquirers	9	2	0.03
conditionalities	16	2	0.03
conditionality	14	2	0.03
conditionally	13	2	0.03
determine	8	2	0.03
memorably	9	2	0.03
watches	7	2	0.03
watchful	8	2	0.03
ascertainable	13	1	0.01
ascertained	11	1	0.01
conduit	6	1	0.01
determinative	13	1	0.01
discover	6	1	0.01
instruct	8	1	0.01
instructing	11	1	0.01
instructs	9	1	0.01
memorable	9	1	0.01
memorizes	9	1	0.01

Table B.13. 2 (Nathans - Word Frequency - Keyword: Learning)

Word	Length	Count	Weighted Percentage (%)
take	4	70	15.77
knowledge	9	39	8.78
read	4	33	7.43
know	4	32	7.21
taking	6	27	6.08
hearing	7	25	5.63
acquisition	11	24	5.41
acquired	8	22	4.95
acquire	7	18	4.05
conditions	10	18	4.05
determined	10	15	3.38
acquisitions	12	14	3.15
determine	9	10	2.25
checking	8	8	1.80
determining	11	7	1.58
takes	5	7	1.58
acquiring	9	6	1.35
check	5	6	1.35
instructions	12	6	1.35
ascertain	9	5	1.13
reading	7	5	1.13
condition	9	4	0.90
determinative	13	4	0.90
instructed	10	4	0.90
seeing	6	4	0.90
determination	13	3	0.68
learn	5	3	0.68
studies	7	3	0.68
ascertained	11	2	0.45
checks	6	2	0.45
instructing	11	2	0.45
knows	5	2	0.45
learning	8	2	0.45
watch	5	2	0.45
ascertaining	12	1	0.23
discovered	10	1	0.23
hear	4	1	0.23
instruct	8	1	0.23
instruction	11	1	0.23
instructively	13	1	0.23
learned	7	1	0.23
teach	5	1	0.23
watched	7	1	0.23
watching	8	1	0.23

Appendix C

SFO - Fraud Complaint Form

SFO - Make a fraud complaint online | Page 1 of 3

SFO
SERIOUS FRAUD OFFICE
Te Tari Hara Tāware

Make a fraud complaint online

Who is your complaint about?

First name

Last name

Company / organisation name

Region

Northland

Details of your complaint

Please provide as much detail as you can, focusing on the alleged criminal offending.

What happened? Who was involved? How much money was involved?

Details

Please attach any relevant documents (max 15MB)

Attachment

Browse...

Attachment

Browse...

Attachment

Browse...

https://www.sfo.govt.nz/complaints 19/01/2018

Attachment

Browse...

Attachment

Browse...

Your details

First Name

Last Name

Email

Phone number

Street number

Street name

Suburb

City

Postcode

Country

Other information

If you have provided information to any other agencies regarding this matter, please indicate them here:

Commerce Commission
Companies Office
Charities Services
Department of Internal Affairs
Financial Markets Authority

Name of agency (if selected other above)

If the SFO decides that your complaint is better addressed by another government organisation, do you agree to us disclosing the details of your complaint and your personal details to that organisation? (required)

○ Yes

○ No

Submit

The Serious Fraud Office
PO Box 7124, Wellesley Street, Auckland 1141, New Zealand
0800 109 800
enquiries@sfo.govt.nz

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